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A Renaissance of Keynesianism?

Karl Brunner, the great Swiss-American economist, published in 1983 a paper in which he addressed the provocative question whether monetarism - the competing paradigm to Keynesian thought - had failed. His conclusion at the time was twofold: as regards its cognitive content the monetarist paradigm had not failed, however, it had failed in the political market, offering in contrast to Keynesianism no saleable product to political entrepreneurs acting in the public arena. Indeed, the danger of the Keynesian product is that its central recommendation of an active management of aggregate demand meets the politians' desire for actionism and their election-induced preference for signalling competence to voters.

Nevertheless, from todays point of view it seems that Karl Brunner was overly pessimistic. After all, world-wide governments have permitted their central banks to eliminate inflation. Moreover, governments have repeatedly declared that producing inflation does not buy additional employment, and in Europe as well as in many other countries central bank acts have been rewritten during recent years in order to make central bankers more independent from governments and the political process. The member states of the European Union have even enshrined the provision of price stability in the Treaty of Maastricht as one of two guiding objectives or principles, the other one being protecting competition in open markets. They have provided the European Central Bank with a status of independence, and they have agreed on upper limits for budget deficits.

These are important achievements. They should make it more difficult to reintroduce Keynesian-type policies in Europe. True, it would be naive to believe that once and for all liberalism has gained the victory over interventionism and Keynesian prescriptions in actual politics. History provides ample evidence that institutions can be undermined, changed or even undone and politicians may be tempted to do so if this raises the probability of their survival in the political arena. We cannot rule out that the temptation to try the Keynesian program will rise if the pressing European problem of high unemployment will not be solved. However, in an open democratic society politicians cannot act independently of common beliefs and public opinion. Their policies need consent, and they need some intellectual backing. This is were the role of the academic economists comes in. They should try to educate the laymen by presenting their views in public, time and again. While - as a rule - politicians rarely adopt specific proposals of academics, at the same time they find it difficult to completely neglect the ruling paradigm. Therefore, if the academic economists themselves do not return to Keynesian prescriptions, it is less likely that politicians will. A renaissance of

Keynesianism in politics presupposes a renaissance of Keynesianism in the economic profession.

Is there a renaissance of Keynesianism in the academic profession? I believe that is not the case. John Maynard Keynes famous work, the "General Theory of Employment, Interest and Money", started the Keynesian revolution and established macroeconomics. Today it is a classic, but who reads classics? While the freshmen in unversities still have to study the Keynesian text book model, they also learn about the deficiencies and about more recent models that avoid some Keynesian pitfalls. Keynes made an important contribution to the history of economic thought but his paradigm has no direct relevance anymore for todays macroeconomic analysis. What was to be learned, has been integrated. In this sense we are all Keynesians.

The Keynesian world

At the center stage of Keynesian type policy programs is fighting unemployment by macroeconomic rather than microeconomic tools. Within in the simple Keynesian framework, as summarized by the income-expenditure approach, it was not very difficult to raise aggregate employment. Unemployment appeared to be the consequence of a permanent lack of aggregate demand. Therefore, the policy recommendation was that government should push aggregate demand by means of higher spending and lower taxing. According to the Keynesian belief an expansionary fiscal policy would generate large multiplicative effects on aggregate consumption and investment. While it was clear that a debt-financed expansion of government spending would induce an increase in the rate of interest, the common understanding was that a rise in the rate of interest could be neutralized by a sufficiently accomodative monetary policy. But note that until about the late 1950s Keynesians did not expect much gain from monetary expansion in the absence of an expansionary fiscal policy. "Money does not matter" was a key slogan.

In fact, an important ingredient of Keynesian theorizing was the belief that money demand was dominated by an extreme preference for liquidity. On the assumption of a very high responsiveness of money demand to the interest rate, monetary policy was confronted with the risk of a liquidity trap, limiting the potency of monetary policy. The validity of this assumption was investigated in numerous empirical studies during the 1960s. The general conclusion from all these studies was that the Keynesian assumption was rejected by the data. In fact, the interest responsiveness of money demand is not high, but rather low. In view of this the proponents of the monetarist counterrevolution declared: "Money matters, and it matters a lot." This notion summarized two major hypotheses: first, the long-run development of the price level depends on the permanent rate of monetary expansion; second, unanticipated changes in the rate of monetary expansion impact on the business cycle by temporarily changing the real rate of interest and the real wage. But note that the impact does not last as agents learn about the true rate of monetary expansion.

The Phillips-curve and the role of inflation expectations

During the 1960s the focus of Keynesian analysis shifted towards a new theoretical concept, the analysis of the Phillips-curve. The conjecture was that there is a stable inverse relationship between the growth rate of nominal wages and the level of unemployment. Paul Samuelson and Robert Solow reformulated this relationship by postulating a mark-up of product prices to changes in nominal wages. Thus the Phillips-curve became known as an inverse relation between the rate of inflation and the level of unemployment. The reformulation laid the ground for the victory of the Phillips-curve as a guiding notion for macroeconomic policy. The Keynesian belief that this relationship was a stable one became attractive to politicians. The implication was that the relationship could be exploited by aggregate demand management. Producing a higher rate of inflation by a more expansionary monetary policy would buy additional employment, hence lower unemployment. When the German chancellor Helmut Schmidt learned about the Keynesian Phillips-curve in 1972, he declared that he would prefer a rate of inflation of 5 percent p.a. to an unemployment rate of 5 percent. Unfortunately, it did not take a long time, thereafter, that Germany experienced both and even higher levels of unemployment and of inflation.

Today we know that Keynesians were wrong. Higher inflation does not buy lower unemployment. Already in the late 1960s Milton Friedman and Edmund Phelps had pointed out that the assumption of a stable trade-off between inflation and unemployment required that employees are troubled by "money illusion". If, and only if, employees do not demand as part of the contract wage a compensation for an inflation-induced fall in the real wage, raising the rate of inflation will increase the effective demand for labor, given that the real wage rate undercuts labor productivity. It goes without saying that in the real world wage contracts are based on the expectations of future inflation as well as of productivity growth. This implies as regards the Phillips-curve concept that the short-run Phillips-curve is not stable but moves with the inflation expectations towards higher levels of inflation. As a consequence, expansionary monetary policy can buy additional employment only if and as long as inflation expectations lag behind the rate of monetary expansion or actual inflation. A permanent gain is impossible because the long-run Phillips-curve is vertical. The expectations augmented Phillips-curve concept implies that the (natural rate) equilibrium level of unemployment is independent of the level of inflation.

This is not to say that switching to an expansionary monetary policy is undesirable at all times. Consider the early 1930s, when economies were troubled by lasting deflation. We speak of deflation when the price level, nominal income and the money supply fall. A deflationary process drives real rates of interest negative and raises the real wage when nominal wages do not respond sufficently to falling prices, because employees or labor unions are reluctant to accept nominal wage cuts. As a consequence unemployment will rise drastically. The policy conclusion is obvious: deflation must not be permitted. In fact, it can be avoided by a turn-around of monetary policy that eliminates the deflation-induced rise in the real wage. Today, it is gwnwrally accepted that central banks shall avoid negative trend growth of the money supply.

On the assignment problem

The important insight that inflationary monetary policy will not yield lasting employment gains is these days built into any macroeconomic model. It has implications for the assignment of the objectives of economic policy. In particular, the overriding objective of monetary policy should be stabilizing the price level because stable money is an important condition for real growth. The objective of high employment, in contrast, is to be assigned to wage policy, tax policy and other types of measures that work on microeconomic conditions. The application of game theory to macroeconomics during the past twenty years has highlighted the strategic importance of the assignment problem. If the central banks are legally obliged to care about the level of unemployment, labor unions have the power to enforce too high wage increases because they will not have to pay the bill. Consequently, they will be tempted to gamble on the central bank' s dilemma of either having to validate excessive wage rates by reflation or of having to take the blame for rising unemployment.

It is noteworthy that the Deutsche Bundesbank, for example, has never accepted responsibility for employment. In fact, the statute of the Bundesbank did not explicitly mention an employment objective. However, there was the provision that the Bank has to support the general economic policy of the German government, provided that this does not endanger maintaining price stability. It has never been clarified, for example by a ruling of the constitutional court, what the content of this obligation might be. In my view, the clause covers only such supportive actions that do not generate inflation expectations. Similarly, the Bundesbank has taken the position that only in the case of a recession a more expansionary policy may be called for.

The insight that the problem of high unemployment cannot be solved by means of monetary policy and that nevertheless governments will be tempted time and again to try out whether the impossible is possible has promoted the idea that central banks should be freed from the grip of governments. The principle has been enshrined in the Treaty of Maastricht. The European Central Bank and the national central banks, who are the member banks of the European System of Central Banks, have been made independent from national governments as well as from the organs of the European Union. The Treaty sets the overriding objective of maintaining price stability. At the same time the Bundesbank statute has been copied by stipulating that the common monetary policy shall support the general economic policy in the European Union. It remains to be seen whether governments will try using this clause for putting some pressure for a more easy monetary policy on the ECB. The former German finance minister Lafontaine has tried it. But it is not clear that his pressure had much support from other member governments.

Lafontaine and his collaborators tried to gain support for a different assignment of macroeconomic policy objectives. According to them wage policy should be geared to the objective of price stability and monetary policy to the objective of high employment. The proposal was that labor unions should negotiate longer-term wage contracts that incorporate expected productivity gains but exclude inflation expectations. Given noninflationary wage settlements, the European Central Bank would be free to set the stage for higher employment and investment by reducing interest rates. It is important to note that the proposal is based on a false view of the macroeconomic interrelationships. Suppose the economy is in the state of price stability and negotiated wages as well as nominal interest rates in capital markets are devoid of inflation expectations. To maintain price stability the central bank will have to signal that money growth will be kept on a neutral path. This implies that the short-term interest rate controlled by the central bank is to be kept in line with the medium and long-term interest rates in the capital market. The latter rates are determined by the demand for and the supply of savings. However, those rates will not be constant but change in response to changes in the preferences for consumption and changes of technical progress. In order to preserve a neutral monetary path the central bank will have to follow with the short term rate, though certainly not in a mechanical fashion.

Thus, the central bank will not be free to choose a low interest rate level in the hope of employment stimulation. Negating this insight would imply to lay the ground for a new wave of inflation. It is useful to recall what the great Swedish economist Knut Wicksell early this century taught his students. The interest rate cut would unleash a rise in the monetary expansion rate, a rekindling of inflation expectations and a rise of nominal interest rates in the capital markets. Under those conditions it would be an illusion to believe that labor unions would stick to the contracts. In sum, the proposal to change the assignment of policy objectives is to be rejected.

Permanent unemployment is a supply-side problem

The persistence of high unemployment in Europe, notably in France, Germany, and Italy, is not of the Keynesian type. At the heart of the problem is not a permanent deficiency of aggregate demand but adverse conditions on the supply side of the economy. Following Milton Friedman, economists are used to speak of "natural" unemployment. The term natural unemployment points to the fact that the characteristics of the economic and social order of a country impact on the level of unemployment. The economic process cannot reduce the natural level of unemployment if those characteristics are not changed by economic policy. Conceptionally, natural unemployment can be differentiated into voluntary unemployment and involuntary unemployment.

Voluntary unemployment is induced by the social security system. If the difference between the net income a person can earn by working and the subsistance payment promised by the social security system is smaller than the disutility from working, the person will prefer to register as unemployed. It must not mean that the person will not work at all, given the option of the underground economy. The aggregate volume of voluntary unemployment can be reduced. It requires to lower the level of social compensation payments. Note that such measures would induce some downward pressure on the wage level and, therefore, are rejected by labor unions.

Quantitatively more important than voluntary unemployment is enforced unemployment. This means that people are ready to work at the going wage rate but do not find a job. The aggregate supply of jobs is smaller than the demand because it does not pay firms to increase the supply of jobs. The profitability of creating additional jobs depends upon the difference between the expected net yield of investment and the real rate of interest in the capital market. Investment decisions are crucially shaped by expectations about the medium to long run, given that most investment decisions lock-in capital in capital for longer periods of time. Naturally, the expectations about trends in the regulation of markets, notably the labor market, about wage policies, tax and social security policies play a decisive role, as do - with a view to Germany - the expectations as regards future energy policy. In principle, governments can do a lot set the stage for permanently higher employment, in practice it seems they try to avoid the hard options.

A renaissance of Keynesian ideas contributes nothing to solving the employment problem. Rather it would serve as a smoke's scream to the necessity of overhauling the economic order. What could be done in important policy fields is well known. Let me simply point out with respect to Germany that the labor market needs to be freed from the grip of the wage cartell. Though the wage contracts negotiated between labor unions and employers' associations have been improved over recent years, collective contracts cannot account for the flexibility needs that arise at the firm level. To achieve a more flexible labor market would require to permit management and employees to negotiate contracts at the firm level that deviate from the collective contract if they so desire. It is unlikely that the unions will be ready for such change of the rules. Therefore, it will be necessary to change the German labor law. If this will not be done, there is not much reason to expect that the German unemployment will fall significantly.

Final Remark

The recent German debate about the merits of a Keynesian-type demand stimulation over supply side measures was unnecessary if not counterproductive. Which type of policy is appropriate depends on the state of the economy. Some demand management is called for when the economy moves towards recession in order to avoid the loss of jobs. Fortunately, recessions are quite rare; Germany experienced no more than four recessions during the past fifty years. In contrast, Germany experiences high persistent unemployment meanwhile for more than twenty years. This reflects a lack of understanding that the economic and social order needs to be reformed by taking appropriate supply side measures. What Germany as well as other European economies need are reforms that aim at deregulating markets, promote competition and redress the size of government, notably the social security system.