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Keynesianism

Introduction

In conventional wisdom, **Keynesianism** refers to Keynesian economic theory and its policy implications based on the ideas of British economist John Maynard Keynes (1883-1946), whose main book, *The General Theory of Employment, Interest and Money,* was published in 1936 (Keynes 1936). Keynesian economics argues that in absence of state intervention, markets often lead to inefficient macroeconomic outcomes such as unemployment and low economic growth. It interprets these critical outcomes as crises of aggregate demand, the latter being made of consumption, investment and public spending in the simplest case of a closed economy. Given the fact that consumption depends on the level of income, while investment on the unpredictable "animal spirit" of investors, the only variable left for governments to regulate aggregate demand (hence the level of economic growth and employment) is public spending.

Keynes' classical framework was later expanded in the box of tools of modern post-World War II macroeconomics, popularized by a new generation of textbooks (Samuelson 1948). This included fiscal and monetary policies to stabilize demand and therefore output over the business cycle. Fiscal policies included pubic spending and taxation, while monetary policies changes in the interest rate and the money supply. This post-war version of Keynesianism — known as the "neoclassical synthesis" built on analytical models first developed by Hicks (1937) — is controversial as it is based on theoretical foundations and policy instruments that Keynes is believed to have rejected (Davidson 2009).

The emergence of Keynesianism

With respect to economic crises, pre-Keynesian economics was based on "Say's law" according to which the main source of demand is the flow of "factor" income generated through the process of production. Demand is thus generated by the increase in supply. Say's law therefore rules out any possibility of systemic demand-deficit crises *once* resources are employed. In its most basic formulation, the mechanism that allows full employment of all resources is wage and price flexibility, through which markets are believed to equilibrate, hence making unemployment a theoretical impossibility.

The Great Depression exposed this orthodox economic theory for its inability to give insights on how to deal with the persistent level of unemployment, at a moment when the threat of social unrest and political instability following the Soviet experience put pressures on Western governments to intervene. Classical

economists' theoretical apparatus, with its implication of *laissez-faire* and its prescription for non-intervention, was increasingly at odds with their "practical conclusions" (Keynes 1937) and proposals of public spending to deal with the crisis.

Keynes understood that unemployment was no longer a means to retrieve profitability and that wages were "downward sticky" (Skidelsky 1992). Hence, in a world in which profit expectations become increasingly uncertain, investors hoard money instead of lending them out for productive investments with an uncertain return. This phenomenon is known as the "liquidity trap". Thus, economic growth could not be re-established through wage flexibility — due to the growing power of organised labour — or a fall in interest rate — due to the "liquidity trap". Only one solution was in sight: if investors stop investing the government needed to expand aggregate demand through an expansion of public spending. Keynes saw this type of fiscal policy as triggering a multiplier process that would expand output above the initial increase in public spending. The initial increase in output induced by public spending would put more people to work thus also increasing consumption. This in turn would have further increased output, and so on. This multiplier effect (originally discovered by Kahn (1931) became the central analytical tool of post-war income determination models and modern macroeconomics.

The spreading of Keynesianism, its demise and current return.

Keynesianism represented an important theoretical, policy and pedagogical rupture with previous practices. Its diffusion and acceptance within academic and policy circles in the US and in the West warranted the label of "Keynesian revolution". This reflected a general consensus on the definition of the economic problem as unemployment, of the means for the solution as economic growth, and of the set of policy instruments through which growth could be managed and achieved, as monetary and, especially, fiscal policies. To have operational validity, this consensus required a "deal" among social forces in society — namely organized labour and capital — that allowed the constitution of a social and institutional context within which Keynesian policies could be implemented without threatening profitability. These "productivity deals", in which the principle of yearly wage increases was accepted by capital in exchange for productivity increases granted by organized labour, allowed to maintain the profit and wage share of total output overall constant, while at the same time granting absolute increases in wages and profit. It is only in this context that the "fiscal multiplier" could be understood as stable, the basic conditions for Keynesian government policies to operate. The institutional arrangement making this possible has been dubbed, the "social microfoundations of macroeconomics" (De Angelis 2000).

Keynesianism entered into crisis in the mid 1970s, in the context of co-existence of high inflation and high unemployment rate (stagflation), and pervasive social unrest, especially from those sections in society that have been excluded from the "Keynesian deal". Following the monetarist critique and the advent of "monetarist" and "supply side" policies in the 1980s, "Keynesianism" as a paradigm based on the triad goal, policy means and instruments was abandoned. What remained was an ad-hoc use of expansionary policy tools such us military expenses in the early 1980s, but with the abandonment of full employment objectives and with the privileging of monetary policies as a general rule. In the last few yeas, especially after the economic crisis of 2008, there is a growing debate about the need to return to Keynesianism, especially understood as "green Keynesianism", i.e. the undertaking of massive public expenditure policies in renewable energy sources, and consequent promotion of employment policies and increase regulation of the economy.

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