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HOW DEAD IS KEYNES FOR NEW KEYNESIANS?

During the 1970s the early Keynesian system was buried as a result of microfoundations. Some of these, however, turned out to be overidealistic (e.g. market-clearing price). The new ideas developed during the 1980s and 1990s, inaugurated the "Keynes after Lucas" age. Nevertheless, it must be admitted that New Keynesians are a very heterogeneous group difficult to describe by the means of unique definition. Furthermore, modern Keynesian economics differs significantly from both Keynes' approach and the old orthodox Post Keynesian school. The purpose of this paper is to investigate where the similarity between Keynes and his followers starts and ends. The following questions are considered: micro-foundations, rigidities, unemployment, expectations, money and monetary policy, fiscal policy and budget deficit. The analysis shows that a very general view of Keynes' writings is still relevant. But at the same time New Keynesians decidedly reject many typical old Keynesian opinions, approving several New Classical and Monetarist suggestions. Most certainly the spirit of Keynes has been rediscovered and New Keynesians are inheritors of the considerable part of his proposals. However, Keynes most probably would not be a New Keynesian.

Keywords: Keynes, New Keynesians, micro foundations, rigidities, unemployment, expectations, economic policy

INTRODUCTION

During recent years the Keynesian paradigm has lost its homogenous structure. Although Post and New Keynesians unanimously emphasize the impact of market failures in an economy, a unique Keynesian model does not exist. On the contrary to the 1950s and 60s when the IS-LM model was a cornerstone of most Keynesian constructions, New Keynesians commonly use only one assumption, namely rigidity. However, New Keynesians propose so many explanations of the stickiness phenomena that it is impossible to formulate a unique peculiarity of modern Keynesians. Mankiw (1997, p. 450) concluded that:

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New Keynesian economics is far different from old Keynesian economics – so different, in fact, that today the label 'Keynesian' may generate more confusion than understanding.

Moreover, New Keynesians' achievements are also far different from Keynes' economics. It is worth citing Mankiw (1997, p. 446) once again:

New Keynesians view their work as following in the broad tradition that evolved from Keynes, but their goal is to explain to the world, not to clarify the views of one particular man. If new Keynesian economics is not a true representation of Keynes's views, then so much the worse for Keynes. The reason for this attitude is clear. Despite its remarkable contribution, the *General Theory* is an obscure book: I am not sure that even Keynes himself knew completely what he really meant. Moreover, after fifty years of additional progress in economic science, the *General Theory* is an outdated book.

The purpose of this paper is to focus and compare the most distinctive features of Keynes' and New Keynesians' approach. Consequently, the following questions that seem to be primary for each economic school will be scrutinized: microfoundations, rigidities, unemployment, expectations, money and monetary policy, fiscal policy and budget deficit. There is no intention to survey every remarkable paper connected to the discussed topic but rather to highlight the most important and often considered issues. The paper ends with some concluding remarks.

1. MICROFOUNDATIONS

One of the most important objections raised to Keynes' theoretical system is the lack of a microbasis. The critics concentrated on the assumption of rigid wages arguing that Keynes had not derived it from pure microeconomic behavior. His scant explanation of sticky wages concerning money illusion, the behavior of trade unions and minimum wage legislation (Keynes 1960, p. 14–15) was not accepted as satisfactory. Moreover, the adversaries emphasized that Keynes had not applied the theory of monopolistic competition, well-known in the 1930s.

However, it must be pointed out that the assumption of rigid wages in the *General Theory* had been only an analytical simplification, not the necessary condition for the final results. Such an attitude could probably excuse the absence of an adequate micro-interest in question. It is also maintained (Davidson 1992, p. 452, 458, 461) that Keynes, by omitting the monopolization of economy, had showed that the equilibrium with

unemployment could occur even without such a market failure. Davidson (1999, p. 575) stressed that the existence of excessive demand for liquidity is the only condition for equilibrium with involuntary unemployment in Keynes' analysis. The effective demand principle shows that the presence of underemployment does not depend on any degree of competition. Keynes had asserted very clearly that his theory is applicable to every level of competition. For this purpose he had also incorporated perfectly competitive market with flexible prices and wages.

Furthermore, Howitt (1986, p. 628) maintained that Keynes had provided a sufficient microbasis, which is exhibited in his theory of effective demand. Keynes in pointing out the role of effective demand, had presented in detail how the entrepreneurs' decisions based on their expectations can influence economic activity. Microeconomic decisions directly affect the macroeconomic variables, since employment, output and national income all depend upon effective demand.

Nevertheless, the opinion that the *General Theory* completely omits microfeatures became a widespread belief. It was substantially reinforced by the neoclassical synthesis' analysis. Hence, New Keynesians intend to provide an accurate microeconomic defense of their macroeconomic conclusions. They are not convinced by the *ad hoc* assumptions and try to investigate the reasons for the downward wage and price rigidity, which is regarded as one of the most important market failures. As Greenwald and Stiglitz (1993, p. 25) stated:

> Incorporating the newer micro-foundations is the principal task ahead of new Keynesians. The challenge is to choose between the myriad of ways in which the market can be imperfect, and to decide on the central questions and puzzles to be explained.

The emphasis on microfoundations by New Keynesians is due to New Classicists' and Monetarists' critique of Keynes and Post Keynesians. Especially influential is the New Classical analysis based on the representative agent's behaviour. This agent uses all available information in order to maximize his utility, which leads to continuous equilibrium in all markets questioning the Post Keynesian explanation of economic phenomena. Its lack of sufficient microjustification of macro effects was obvious. Ironically, the stage of challenging the Keynesian viewpoints was the beginning of their reincarnation. The attempt to refute the neoclassical charge gave an incentive to initiate the "New Keynesian era".

2. RIGIDITIES

In the first eighteen parts of the *General Theory*, Keynes had analyzed macroeconomic phenomena assuming explicitly rigid wages. This reasoning is treated as a crux of his theoretical system to the present day. Moreover, it is often argued that Keynes' conclusions depend strictly on this postulate. Such a view is very surprising, since Keynes had admitted that it was only a temporary simplification, dropped in the nineteenth part. He had also stressed very clearly that the elasticity of wages and prices could not be a solution for macroeconomic coordination failures. Keynes was convinced that to augment the level of employment one must raise the level of aggregate demand, keeping the rate of nominal wages unchanged (Keynes 1960, p. 260 – 261, 267).

The belief that Keynes' outcomes are relative to sticky wages was propagated by the neoclassical synthesis, especially John R. Hicks (1937) and Franco Modigliani (1944). However, they imposed this presumption without any theoretical rationalization. It was a typical *ad hoc* assumption.

New Keynesians continue the tradition initiated by Hicks and Modigliani, considering rigidities concerning both wages and prices as the heart of Keynesian economics. Nonetheless, they try to explain it on the ground of microeconomics. The search for microfoundations is the common component bringing together almost all New Keynesians. It is often claimed that insistence on microbasis is what distinguishes New Keynesians from Keynes and Post Keynesians. Evidently, a contemporary complication of both the economic situation and microapparatus advanced the analysis. The fundamental issue for New Keynesians is to make a distinction between nominal and real rigidities. Such a division indicates that nominal rigidities are the main source of economic fluctuations. Although real rigidities alone could not produce large disturbances, together with nominal frictions they have a large effect on economic activity. The most popular New Keynesian papers examining the nominal rigidity of wages and prices were presented by Mankiw (1991), and Akerlof and Yellen (1991). Both concepts of menu costs developed by Mankiw and near-rational behaviour originated by Akerlof and Yellen, showed how small nominal frictions on a microlevel can result in a large macroeconomic nominal rigidity. However, Ball and Romer (1991) for example showed that small nominal frictions produce only small rigidities.

Most New Keynesians maintain that economic fluctuations arise from the problem of rigid (nominal or real) prices and wages. Consequently, they

continue the belief that the Keynesian models must embody the phenomena of stickiness, which disturb the correct economic mechanisms. In their opinion rigidities are the main reason why a market economy differs from the Walrasian model. Without such stickinesses flexible prices and wages would allow the economy to adjust quickly to disturbances. This attitude is strongly criticized by many Post Keynesians arguing that the rigidity of wages, much less of prices, is not a theoretical basis of Keynes' reasoning. Tobin (1975, p. 201–202) affirmed that rigid nominal wages ensure the stability of aggregate demand, while the elasticity of wages produces a coordination problem in the labour market because of insufficient information. Hence, even if wages and prices were perfectly elastic, the output and employment would be highly volatile. Also Post Keynesians such as Davidson and Kregel (1980, p. 144) shared this attitude:

> Since all exchange values are relative and since the current values of all resaleable durables ultimately depend on their expected future spot process, the only thing which will provide an anchor for the money price level over time is the belief in the stability or stickiness of money costs of production over time. Hence as long as forward labor contracts are set in monetary terms for a period of calendar time which exceeds the gestation period of production, economic agents can expect stickiness in the price level of new goods and services. It is the money wage contract and the resulting stickiness of money wages which permitted Keynes to produce a stable but potentially shifting equilibrium model.

Arestis and Sawyer (1998, p. 183) underlined as well that many factors termed 'imperfections' may play a positive role in economy. For example long-run labor contracts contribute to workers' training and education, workers' greater commitment to the enterprise and they prevent disadvantageous relations between employees and employers. Similar arguments refer to the trade unions, minimal wages etc. All these factors should positively affect productivity.

Most New Keynesians impairing the first-order role of rigidities point to financial, especially credit, market failures and imperfect indexing. Their models usually contain the following components (Greenwald and Stiglitz 1993, p. 26): risk averse firms (Greenwald and Stiglitz 1990), credit rationing (Stiglitz and Weiss 1991), theories of labour market embodying efficiency wages (Yellen 1991) and insider-outsider hypothesis (Lindbeck and Snower 1986). These components help to explain how price elasticity causes macroeconomic fluctuations and unemployment. Particularly, models with risk averse firms and credit rationing demonstrate why small economic

disturbances can create large changes in output, while the theories of labor market show why these output changes generate unemployment.

3. UNEMPLOYMENT

Keynes had rejected the opinion that equilibrium is always attained at full utilization of production sources (Keynes 1960, p. 25–26). In his system such a situation could be only an exception to the rule (Keynes 1960, p. 28, 249–250). In this way he had questioned the classical economists' attitude of treating unemployment as voluntary. Keynes had pointed out that usually aggregate demand equals aggregate supply at the partial utilization of production sources and the resulting unemployment is always of an involuntary character (Keynes 1960, p. 15). In Keynes' opinion, this phenomenon arises from the insufficient effective demand. All the actions undertaken in order to cope with unemployment should concentrate on ensuring the adequate level of aggregate demand (Keynes 1960, p. 30–31). The fundamental cause of unemployment had been deduced not from imperfect competition but from the problems connected to the usage of money. That is why Keynes had demonstrated that even under lack of any market imperfection an underemployment equilibrium is possible.

New Keynesians agree with Keynes on the character of unemployment. Since markets clear only gradually, New Keynesians usually view the level of unemployment as too high and too volatile. They oppose Monetarists and New Classicists, who conclude that the labour market is always in equilibrium and the actual unemployment is entirely voluntary and peculiar to real circumstances. Many New Keynesians underline the imperfect competition in the labour market and provide the microfoundations of wage setting based on the negotiations (Layard et al. 1991). The other stress is the predominant role of real wage rigidity. This is rationalized in three ways: implicit contracts (Azariadis 1975, Azariadis and Stiglitz 1991); insider-outsider models; theories of efficiency wages. Some New Keynesians insist that the main cause of non-cleared labour market is nominal wage rigidity and others emphasize imperfect information. All these various reasons induce the phenomenon of involuntary unemployment, which requires some actions on the authorities' side.

New Keynesians clearly underline the supply-side problems, not the demand-side, as the predominant cause of equilibrium with involuntary unemployment. In Davidson's (1992) opinion the foundations of New

Keynesians' research are conceptually useless for an explanation of Keynes' unemployment analysis. New Keynesians omit Keynes' considerations about necessary and sufficient conditions for underemployment equilibrium in both the short- and long-run and political decisions required to restore and maintain full employment. Davidson (1992, p. 452) wrote:

If New-Keynesians read Keynes's analysis of aggregate supply and demand, however, then they would realize they can not claim Keynes as an intellectual forefather.

4. EXPECTATIONS

In the *General Theory* expectations play a crucial role. Every agent is influenced by both short- and long-run anticipations and his decisions determine the level of investment which are fundamental for the state of the economy (Keynes 1960, p. 46–47). Every microeconomic action is underpinned by expectations. In spite of that Keynes had not specified rigorously such an essential for his system element. He had treated all sorts of expectations in the same manner. In fact he had agreed that the kind, intensity and tendency of expectations are independent of the type of undertaken investment. Besides, the entrepreneurs' expectations had been shown as unpredictable, hence it is impossible to formulate them in rational terms. Keynes had written openly about the agents' "animal instincts" (Keynes 1960, p. 161). However, Meltzer (1996) suggested that the expectations in the *General Theory* are for various reasons, similar to the rational expectations.

Numerous Post Keynesians, among other Joan Robinson and George L. S. Shackle, pointed out that the instability of expectations should be treated as a principal feature of Keynes' model. New Keynesians also accept anticipation as a very important element, but their attitude was forced rather by the manifestation of new classical rational expectations hypothesis (henceforth REH). This theoretical achievement questioned the Keynesian explanation of the economic phenomena. However, New Keynesians succeeded to incorporate REH in order to maintain their traditional conclusions concerning non-cleared markets and the role of stabilizing policy. New Keynesians started to construct models including REH and nominal (price and/or wage) rigidities showing that activist monetary policy with that well-known money supply rule can affect output and employment after all (Fischer 1977, Phelps and Taylor 1977). Nowadays, many New

Keynesians introduce the assumption of rational expectations into their traditional models. However, it must be pointed out that for example Tobin (1980, 1981) and Davidson (1982/83, 1987) have never accepted REH, criticizing its theoretical and methodological assumptions and questioning its general character.

5. MONEY AND MONETARY POLICY

Keynes had been interested above all in short-run occurrences. Hence, his study concerning the role of money and monetary policy had referred to the short-run. In the *General Theory*, money has a major role in increasing employment through affecting the interest rate and the level of investment. Hence, the monetary authority can heighten employment by the means of money supply growth. It does this by lowering the interest rate, which increases the level of investment and the level of income (due to the multiplier). The effect of the monetary policy depends upon (Dillard 1960, p. 178): the decline of interest rate in response to the money supply growth; the sensitivity of investment to the interest rate decline (the elasticity of the marginal capital efficiency function); how much the given increase of investment raises the income (the investment multiplier). However, Keynes had also shown the situation when even a very large money supply growth only lowers the interest rate a little. This occurs when this increase induces such an uncertainty that the liquidity preference is dominated by the precautionary motive and the whole money is thesaurized. Therefore, the increase of money supply would not lead to the lowered interest rate, if the liquidity preference rose more than the amount of money (Keynes 1960, p. 172). Also the lowered interest rate, *ceteris paribus*, would not have to result in favourable effects, if the marginal efficiency of capital fell more than the interest rate (Keynes 1960, p. 173). Keynes had been conscious of the inefficiency of monetary policy under depression when the liquidity preference is high and the entrepreneurs' expectations of profits are low. It is very symptomatic that Keynes' opinion about monetary policy had been rather critical and expressed a lot of doubts concerning its efficiency. He had not believed in the success of monetary policy used alone. It is also worth mentioning that Keynes is usually regarded as an advocate of discretional monetary policy. However, one of his statements clearly denies such a view (1960, p. 203):

> ... Monetary policy which strikes public opinion as being experimental in character or easily liable to change may fail in its objective of greatly reducing the long-term rate of interest ... The same policy, on the other hand, may prove easily successful if it appeals to public opinion as being reasonable and practicable and in the public interest, rooted in strong conviction, and promoted by an authority unlikely to be superseded.

The role of money and monetary policy in Keynes' theory was depreciated by the neoclassical synthesis. Its considerations made very famous a conclusion that "money does not matter". New Keynesians on the one hand go back to the roots of *General Theory* by announcing the short-run non-neutrality of money. On the other hand, however, they are very close to Monetarists, since they believe that the money supply curve is vertical for a long time. For that reason Mankiw and Romer (1991, p. 3) stated that much of New Keynesian economics could be called new monetarist economics. Goodfriend and King (1997) wrote about the new neoclassical synthesis, since the long-run neutrality of money incorporates new classical assumptions of inter-temporal optimization and rational expectations into New Keynesian models based on the imperfect competition and costly price adjustments.

The most famous papers combining Walrasian features with a typical Keynesian approach in the context of monetary policy emerged in the mid 1970s as a response to the New Classicists' and Monetarists' critique. Two classical studies, mentioned previously, by Fischer (1977) and Phelps and Taylor (1977) showed how monetary policy under rational expectations and long-term nominal wage contracts can stabilize production and employment in the short term. In the long term, however, monetary policy loses its stabilizing power. Almost all New Keynesians agree to the short-term non-neutrality and long-term neutrality of money supply. Owing to such an attitude the potential role of stabilizing monetary policy is restored (at least in a short run). New Keynesians also share a common view that under flexible prices and wages, money should be neutral, except the mentioned above group of New Keynesians who reject the first-order role of rigidities. Greenwald and Stiglitz (1993, p. 26) asserted that even under a greater elasticity of wages and prices monetary policy maintains its properties, since flexibility increases the problem of economic fluctuations. However, Davidson (1999, p. 576–578) asserted that New Keynesian assumption of long-term neutrality of money is inconsistent with Keynes' theory of effective demand. Since money affects strongly the actual short periods, it is impossible to form long-term predictions without knowledge about money

behaviour between the first and last stage. Davidson argued also that Keynes had clearly rejected the classical proposal of short- and long-term neutrality of money, even under perfectly flexible wages and prices. Even if prices and wages were elastic in the long term, the existence of money would generate booms and depressions. In the *General Theory* there is no self-adjusting mechanism which would assure cleared markets, even if wages and prices were perfectly elastic.

Unlike Monetarists, most New Keynesians doubt the power of fixed policy rules. Underlying both the impact of uncertainty and instability of economic life, and the lags in effects of monetary policy, New Keynesians question the potency of monetary principles established in advance. They promote the necessity of intervention in the face of large, persistent disturbances, since the adjustment processes in the economy are too sluggish. Hence, the changing economic environment requires changes of monetary policy.

6. FISCAL POLICY AND BUDGET DEFICIT

Keynes had propagated the progressive taxation of high incomes simultaneously with increased social services intended for the poorest. Since the propensity to consume is low at high levels of income, this taxation would only slightly diminish the amount of consumption, while reducing the amount of savings significantly. On the other hand, low incomes augmented by the transfers would increase their consumption expenditures (Keynes 1960, p. 372–373). However, Keynes had pointed out that highly progressive taxes could restrain the amount of investments undertaken, even if the interest rate is low. To maintain the optimal level of investment, taxes should rise moderately (Hansen 1953, p. 220). Keynes had also proposed managing public investments to offset the lowered level of private investments, though only in a situation of unemployment growing dangerously (Keynes 1960, p. 126–127). Together with increased social services and only moderately progressive taxes, it must have spelt a budget deficit. Although he had warned against the crowding-out effect connected to the financing of public investments (Keynes 1960, p. 119), he had treated the rising budget deficit as a means of necessary stimulation. In Keynes' opinion, government could be indebted to commercial banks or directly to society by selling bonds. In the first case, there would be an increased credit money supply. In the second, the government would use a part of society's deposits. This way of covering

the augmented expenditures and budget deficit leads to increased public debt. Keynes had believed that this is one of the forms of redistribution, which would not diminish the social wealth, since only foreign indebtness is a serious problem (Sołdaczuk 1959, p. 199–202; Górski and Sierpiński 1987, p. 349–351).

The role of active fiscal policy was emphasized by Post Keynesians, who preferred such actions to the effects of monetary policy. They also did not exaggerate the problem of budget deficit relying on the favorable effect of multiplier. New Keynesians, similar to Post Keynesians, are convinced that a market governed by the "invisible hand" cannot automatically attain equilibrium, and that markets (above all the labor market) respond very sluggishly to the shocks, *i.e.* prices and wages do not move quickly enough to clear the markets. Hence, government intervention is necessary. But a trust in the reliability of government activity is not as unquestionable as before. Just as in the case of monetary policy, they point out that it is very difficult for government to choose an appropriate moment for intervention due to time lags in its effects. Hence, most New Keynesians prefer rather '*coarse tuning*' than '*fine tuning*'. The latter could fail because of lack of adequate information and forecasting potentiality. The former concentrates on assuring a sufficient level of aggregate demand in the medium period by means of balancing taxes and government expenditure on one hand and savings and investments on the other (Arestis and Sawyer 1998, p. 187).

New Keynesians underline institutional reforms in the labour market, especially changes in acts of job protection (minimizing turnover costs) and the actions undertaken in order to restrict the possibility of strikes. Furthermore, they propose to create the possibilities of increased workers' mobility, training prospects and workers' share in profits. They also recommend improvement in unemployment benefits and insurance system which should induce workers to take up a not quite suitable job. Some of them propose income policy reform to modify the unfavorable effect of uncoordinated wage bargaining. New Keynesians also differ from Keynes' and Post Keynesians' opinion concerning high deficit and public debt. They are not treated as economically and socially beneficial anymore. It is noticed that a high budget deficit leads to decreased savings which in turn generates a reduction in the rate of growth.

CONCLUDING REMARKS

New Keynesian theoretical assumptions are very manifold. Sometimes they are even mutually inconsistent. Distinguishable incoherence of New Keynesians' conclusions produces certain problems in separating them as an independent school. After all this great number and heterogeneity of New Keynesian views play an important and favorable role. Owing to this situation it is possible to highlight very complicated interdependences existing in every economy. Thereby they also avoid narrow-minded analysis and opinions.

All the aspects touched above show that a very general view of Keynes' writings still comes into consideration. But at the same time, New Keynesians decidedly reject many typical old Keynesian opinions, approving several New Classical and Monetarist suggestions. New Keynesians, agreeing with Keynes, underline that the real world does not reflect Walrasian principles, hence one should undertake some actions to support economic mechanisms. While Keynes had insisted on the lack of sufficient demand resulting from the working of a monetary economy, New Keynesians concentrate on various sources of market failures, above all, nominal and real rigidities, relevant to the supply-side of economy. Clearly, modern Keynesians admit that the disturbances can arise from both demand (*e.g.* the changes in monetary or fiscal policy cause stochastic changes in the private sector) and supply (*e.g.* productivity shocks or shifts in supply functions of production factors) side of the economy (Fischer 1988, p. 306). However, the coordination failures stemming first of all from rigidities are still the core of the New Keynesian approach. Most of their attention is directed towards providing the solid microfoundations of sticky prices and wages behavior. Such an attitude preserves the impression that both Keynes' and New Keynesians' models cannot dispense with the assumption of rigidity. It also sheds light on the way of explaining the unemployment phenomena. Keynes had deduced it explicitly from insufficient effective demand showing that the issue of rigid wages or any other market imperfection is irrelevant. New Keynesians share Keynes' opinion that unemployment is usually of an involuntary character and claims for coming through this socially important problem. However, they emphasize the supply-side puzzles, omitting the crux of Keynes' interest.

The theoretical divergences between Keynes' and New Keynesians' approach reflect in policy proposals. Keynes suggested the monetary and fiscal instruments in order to enlarge the insufficient demand and to

overcome the problem of persistent involuntary unemployment. His propositions of active monetary (money supply growth by lowering the interest rate) and fiscal (progressive taxation of high incomes, increased social services and public investment causing a higher budget deficit) policy had been, however, rather cautious. He had stressed many constraints of government and monetary authority's intervention, exhibiting many examples of its inefficiency. The uselessness of such proceedings had been connected to the uncertainty and agents' unpredictable behaviour. New Keynesians also underline many problems relevant to the proper policy decisions. It arises, however, rather from the multiplicity of proposed market failures. Their different sources claim for equally different cures which appear to be often mutually contradictory. The lack of a unique New Keynesian model causes inconsistency in policy proposals. Furthermore, New Keynesians often share Monetarists' opinions of guiding the policy.

The short sketch of chosen theoretical and practical questions reveals that most certainly the spirit of Keynes is recovered and New Keynesians are the inheritors of a considerable part of his proposals. Their way of thinking and perceiving of the real world, however, differs significantly in many aspects from that associated with Keynes. Those discrepancies are critical, hence one could state that most probably Keynes would not be a New Keynesian.

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