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Speech

Keynes for Today – Lessons for the Left

Lord Skidelsky

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Lord Robert Skidelsky
PEF Council member, crossbench peer and Emeritus Professor of Political Economy

The following is a transcript of PEF Council member Lord Skidelsky's address 'Keynes for Today: Lessons for the Left', part of PEF's series of public lectures on macroeconomic Issues. The event marked the launch of his latest work *Money and Government: A Challenge to Mainstream Economics*.

The views expressed here are those of the author, and not necessarily those of the Progressive Economy Forum.

Labour's relationship to Keynes

Labour has always been set a higher standard on the economy than the Conservatives: they've had to be more orthodox, more competent, more successful to win equal praise or escape equal blame.

The reason is not hard to find: created and financed by the trade unions, and committed to the abolition of capitalism, the Labour Party faced obvious difficulties in guaranteeing what Keynes called a "political and social atmosphere congenial to the average business man". Not that it necessarily wanted to: it was torn between wanting to 'manage capitalism' better than the Conservatives and the desire to achieve socialism. This was the topic of my first book, Politicians and the Slump: The Labour Government of 1929-31.

Between 1945 and 1975, Keynes solved the problem. Keynes offered a middle way between capitalism and socialism. Macroeconomic policy would secure growth and full employment. Sufficiently strong trade unions and redistributive taxation would ensure that the fruits of growth were fairly shared. Under Keynesian social democracy, the 'average businessman' would no longer call the shots.

A key text of this period is Anthony Crosland's The Future of Socialism (1956). Socialism, he said, was not about public ownership, it was about equality and fraternity. Public ownership was no longer an important means for achieving socialism's goals. This was because the old capitalist economy had been replaced by a mixed economy of public and private sectors. The significant players in the private sector were managers, not owners. Capitalists had become pussy cats.

Of course, I am caricaturing, but not by much. The idea that a combination of the managerial revolution, Keynesian demand management, high social spending, and strong trade unions had modified the nature of capitalism was common on both sides of the Atlantic. In his book, American Capitalism (1952), J. K. Galbraith formulated his theory of countervailing power.

We need to add one further modification, not much mentioned at the time: a high level of tariffs which shielded both employers and employees from international competition, and restriction of outward capital movements. Globalisation was still far in the future. We know that the Labour leader Hugh Gaitskell failed in his attempt to implement Crosland's message and abolish Clause IV of the Labour Party's constitution, which pledged it to the common ownership of the means of production, distribution, and exchange.

But Gaitskell's successor, Harold Wilson, brilliantly repositioned Labour as the party of economic growth, of science, and of the upwardly mobile professionals, as against

the fuddy-duddy Conservatives who had produced "thirteen wasted years". "Economic growth" said Wilson, "sets the pace at which Labour can build the fair and just society which we want to see." Economic growth would be achieved by demand management in the context of a medium-term plan for growth.

However, Labour's felt need to make itself seem more orthodox than the Conservatives led to the biggest mistake of Wilson's premiership: the failure to devalue the pound in 1964. In a remarkable pre-run of George Osborne's austerity, it led to three years of stagnation, and a growth rate over the six years of Labour government lower than that achieved by the Conservatives.

Later, Labour were left to pick up the pieces after Conservative mismanagement of the economy between 1970 and 1974, before being swept away by Margaret Thatcher and her revolution. James Callaghan, Labour's last premier before Tony Blair, sounded the funeral note of this era when he declared in 1976: "We used to think that you can spend your way out of recession… I tell you in all candour that that option no longer exists, and that insofar as it ever did exist, it only worked on each occasion by bigger dose of inflation into the economy, followed by a higher level of unemployment…" A new story had taken hold. The narrator was Milton Friedman, and it dashed the Left's hopes of "building the fair and just society which we want to see".

Pre-crash orthodoxies

To get a sense of the constraints facing the Blair-Brown governments of 1997-2010, we must grasp the magnitude of the shifts in climate of opinion in the 1980s and 1990s. These resulted in the dismantling of the intellectual and institutional structure on which the Left relied to achieve its goals.

Here are just a few signposts on the road. We start with ideas.

First was the advent of monetarism, with Milton Friedman's assault on Keynes. Friedman claimed not only that Keynesian policies of full employment led to inflation, but that – provided inflation was controlled – the economy would be cyclically stable at its natural rate of unemployment. That is to say, uncontrolled money was the one flaw in an otherwise optimally self-regulating market system. Friedman's further claim that inflation was a purely monetary phenomenon also ruled out as futile Keynesian attempts to restrain the rise in prices by trying to limit the rise in costs.

In the British version of monetarism, the source of inflation was budget deficits: hence the demand for balanced budgets. Since voters were opposed to higher taxes, 'balance' implied cutting down the public services.

Second, and parallel to this, was the rise of 'public choice theory', or the 'economics of politics'. This claimed that politicians and civil servants were mainly motivated by self-interest rather than by any concern for the public good. Bureaucrats aimed to maximise their departmental budgets, politicians to maximise their votes. Best would be to avoid discretionary policies altogether. This theory of 'government failure' provided a powerful argument for a limited state, in which politicians were restrained by fiscal rules, and policy placed in the hands of independent central banks.

A third influence was 'supply side economics', sometimes called Reaganomics. Its aim was to remove market distortions like high marginal tax rates in order to improve the incentives to 4 work and save, and to remove labour market rigidities in order to lower the natural rate of unemployment. Increased inequality and curtailment of welfare entitlements were necessary consequences of both, but by raising the growth rate such policies would improve the lot of all.

Fourth, people started reading Hayek again. In his Road to Serfdom (1944) Hayek had claimed that Keynesian social democracy was the slippery road to totalitarianism. The rapid growth of the state from the 1960s suggested that Britain and other western democracies were well along the slippery road.

The fifth ideological milestone on the road to the defeat of the Left's project was the collapse of communism in the late 1980s. This opened the road to globalization.

Changes in the structure of the economy, partly inevitable, partly contrived, also weakened the institutional bases of Keynesian social democracy.

First, the decline of the white working class eroded Labour's traditional class base.

Second, the replacement of a manufacturing-based by a service-based economy led to a deunionisation of the British labour market.

Third were Margaret Thatcher's labour market laws, sale of council houses, and privatisation policies.

We need an urgent analysis of the reasons for the overthrow of Keynesian social democracy. In my book, I reject the Friedman story that it was because it was inherently inflationary. There was a strong input of anti-state ideology. But this is something which needs discussion, because the Friedman story became the orthodoxy.

The new orthodoxy was given classic expression in Nigel Lawson's Mais Lecture of 1984: "It is the conquest of inflation, and not the pursuit of growth and employment, which… should be the objective of macroeconomic policy. And it is the creations of

conditions conducive to growth and employment, and not the suppression of [inflation] which should be the objective of microeconomic policy."

This amounted to the theoretical abolition of the Keynesian Revolution.

Labour's macroeconomic framework, 1997 to 2007

Faced with an intellectual climate and economic structure hostile to the Left's political project, Blair and Brown – after having finally got rid of Clause IV – endorsed and to a large extent devised a macroeconomic constitution which aimed to portray the economy as being 'safe' in Labour's hands. This built on the new orthodoxy. The Bank of England Act of 1997 mandated the Bank of England to "maintain price stability" [defined by the government] and "subject to that, support the economic policy of Her Majesty's Government". The Bank's Monetary Policy Committee was empowered to set the level of official interest rates independently of government.

For fiscal policy, Gordon Brown's 'golden rule', also announced in 1997, was that "over the economic cycle, we will borrow only to invest and not fund current spending". To this was 5 added a 'sustainable investment' rule: "public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level".

These were tougher than any rules the Conservatives had set for themselves.

Labour also adopted an 'active' version of 'supply side' policy. It aimed not to de-regulate labour markets but to equip workers with higher skills through government training and work programmes. The traditional left-wing goal of reducing inequality was replaced by a pledge to end absolute poverty.

Over the 10 years 1997-2007, the new macroeconomic constitution seemed to work reasonably well. Labour stuck to its fiscal rules. Unemployment and interest rates fell, growth was reasonable. Inflation was subdued. However, this good record masked three troubling weaknesses, and left one important question unanswered.

First, balance on current spending was achieved by redefining when cycles started and ending, and balancing early surpluses against later deficits.

Second, capital spending was kept within the prudent 40% debt/GDP ratio by extensive use of the Private Finance Initiative (PFI) to build hospitals, schools, and some extensive transport projects. PFI replaced spending financed by issues of public debt with spending undertaken by private firms for which they were repaid by leasing agreements with the government over a period of up to 30 years. PFI added nothing to current public debt, but enlarged future public debt.

Finally, the government relied unduly on inflated profits from the property boom and financial sector to balance its books. When tax receipts from these sources fell sharply during the crisis of 2008, the public sector was revealed as having lived beyond its means. Labour's pact with the Mephistopheles of high finance ruined it in the end.

The conclusion I draw is that the maintenance of full employment over the Blair-Brown years depended on sleight of hand: publicly subscribing to the new orthodoxy, but trying to get a bit of Keynesian full employment policy through the back door.

The unanswered question is whether monetary policy actually worked. Mervyn King conceded that the Bank of England had benefitted from a 'nice environment'. Most economists now think that inflation was kept low not by central bank policy but by the entry of billions of low-wage East Asian, mainly Chinese, workers into the global labour market.

The failure of prevention and cure

It's pretty obvious in retrospect that the requirements for maintaining economic stability were grossly underestimated, both on the fiscal and monetary side. Remember the Friedman doctrine: if inflation is controlled, the economy will be stable. This ignored Keynes's crucial insight that a market economy is inherently unstable because investment prospects are inherently uncertain. Fiscal and monetary policy, he said, therefore, have a decisive role to play in maintaining growth and employment.

Further he argued that monetary policy on its own is too weak either to prevent a collapse or produce a recovery. So they need to be coordinated. Let me pursue both lines of thought, starting with fiscal policy.

I have already summarised the theoretical background to pre-crash fiscal policy. The new orthodoxy, exhibited in Lawson's Mais lecture of 1984, deprived fiscal policy of any active role in demand-management. This was enshrined in Gordon Brown's fiscal rules. The effect of these rules was to retire fiscal policy from the prevention of economic collapse.

Once the economy, did collapse, fiscal policy was briefly brought out of retirement, but soon put back in its box. The context is that in rescuing banks from disaster in 2008-9, governments transformed a great deal of private debt into public debt. Conservative rhetoric was then able to reverse the causation: the crisis was caused by the build-up of public debt, and could only be resolved by cutting the deficit to zero as quickly as possible.

Of all the arguments supporting the Osborne austerity policy, the one which resonated most was that the government was like a private household. Everyone knows, so ran

the argument, that if a household's income falls it has to reduce its consumption. It can borrow temporarily, but the loan must be paid back by saving even more. Ditto for a government. If its revenue falls, as a result of the slump, it needs to cut its own consumption. Any temporary borrowing should be repaid as quickly as possible. This was the logic of Osborne's austerity programme.

The obvious reply is that the government is not like a household. If a single household cuts its spending this will affect only itself. If the government – which spends 40% of the national income – cuts its spending, it affects everyone else's spending, because the government's spending is part of almost everyone else's income. Therefore, the correct policy in a slump is for the government to increase its deficit, not reduce it.

Given the political difficulty of putting this message across, you'd think that the economics profession would be shouting it from the rooftops. But this was no longer the Keynesian economics profession. The economists were hopelessly entangled in doctrines which either stated that the economy was always at full employment – and therefore extra government spending would simply be taking away money already being used by the private sector – or that failure to slash the deficit would lead to a flight of money from the country, leading to a rise in all interest rates, including the government's. Conversely – so taught the favourite economist of 2010, Alberto Alesina – a 'credible programme of deficit reduction', particularly cutting spending on the poor, would soon reverse the slump as private business regained the 'confidence' to invest.

Let me say that the only economic columnists in the UK who stood out against the Gadarene rush to austerity were Martin Wolf of the Financial Times, Larry Elliott of the Guardian and William Keegan of the Observer, to whom I should add yours truly, sometimes joined by Marcus Miller and Felix Martin. I remember a dinner with Paul Krugman in 2012, when he said: "What's wrong with your economists?" It is a dismal episode, which is described fully in chapter 8 of my book *Money and Government*.

The consensus today is that Osborne's 'expansionary fiscal consolidation' delayed recovery by at least two years. Its cumulative effect over six years was to destroy productive capacity and leave households £4000 to £13,000 poorer than they would have been had the government properly stepped into the breach.

Now I turn to the failure of monetary policy. The pre-crash story is quite simple. The price level was controlled, but money was set free to wreak havoc in the financial system. Why was this?

Extraordinary as it now seems, the Bank of England's main macroeconomic model between 2004 and 2010 omitted banks from its grouping of key economic agents. As I explain in chapter 8 of my book, this omission was the result of treating banks as mere

intermediaries between utility-maximising households and profit-maximising firms. Captivated by the idea that money 'plays no part of its own', only the part allotted to it by the monetary authority, central banks failed to identify the build-up of fragility in the financial sector, a fragility made worse by the octopus-like spread of derivative instruments.

The lack of special attention to the financial sector had a specific theoretical basis in Eugene Fama's efficient market theory. According to Fama, all the risks run by banks are calculable, and therefore all the loans they made will be accurately priced on average. Banks could thus be safely left free to roam the world, placing their bets where they wanted. This ignored Keynes's crucial distinction between risk and uncertainty. Little wonder that Alan Greenspan, chairman of the Fed in the early 2000s, later admitted that the "under-pricing of risk worldwide" had destroyed his intellectual system.

I turn next to the role of monetary policy in the recovery. QE – quantitative easing – was designed to offset fiscal consolidation. The central banks of the world started buying up government debt on a huge scale. The theory was that by so doing they could pump money into the economy to any extent required to restore aggregate spending to normal. Here too they ignored Keynes's warning that 'money plays a part of its own'. He wrote in 1936: "If we are tempted to assert that money is the drink which stimulates the system to activity, we must remind ourselves that there may be several slips between the cup and the lip." In other words, they completely ignored the existence of 'liquidity preference', the preference for holding assets in liquid form, rather than spend it buying currently produced goods and services.

Though some of the new money trickled into the economy, much of it went into cash reserves or purchasing liquid assets. We are left with a whole lot of speculative cash sloshing round the global financial system, setting the scene for the next financial crash.

The macroeconomic consequences of rising inequality

Many would deny that the crisis had a structural cause. They see it as a random shock. But as with many forms of cancer one can detect pre-disposing factors. The one I would single out for economic diagnosing is rising inequality, which was partly the result of supply-side economics, whose aim was lift the growth rate by redistributing wealth and income from the poor to the rich.

Keynes had pointed out the flaw in any such strategy. He said that the more unequal the distribution of wealth and income is, the more difficult it will be to maintain continuous full employment. This is because the rich save a higher fraction of their incomes than do the poor. Growing inequality thus creates a contradiction. The more

unequal the society, the greater the investment needed to keep the economic machine going; yet the smaller are the earnings available to buy the increased output from the investment. Hence, barring steps to reduce inequality, consumption will become increasingly dependent on debt; and the savings of the rich will be increasingly employed in speculation rather than in expanding the output of consumer goods.

Something like this happened in the run- up to 2008, exacerbated after 2008 by the lopsided nature of quantitative easing. Advanced country data show a sharp rise in the share of the post-tax income going to the top 1%; real hourly earnings lagging well behind the growth in labour productivity; a fall in the share of median, or typical, family income as a percentage of average family income; and a fall in the share of wage income in GDP.

Thus, the main effect of the Reagan-Thatcher supply-side reforms was not to speed up the rate of growth, but to speed up the growth of private debt. In the UK, household debt (consumer debt plus mortgages) rose from 70% of GDP in the 1980s to 148% in 2008. Financialization – a measure of the ratio of financial transactions to total economic transactions- rose from 70% of GDP in advanced economies in 1980 to over 450% in 2011. With massive inflows of Chinese money keeping interest rates low, cheap access to credit became the new form of the social contract.

As the economist Thomas Palley pointed out in 2008, the American economy "relies on asset price inflation and rising indebtedness to fuel growth". What had to be done was to restore the link between wages and productivity. That way "wage income, not debt and asset price inflation, can again provide the engine of demand growth".

Thus, the excess credit creation, which Hayekians see as the cause of the financial collapse of 2007-8, can, on further reflection, be seen to be rooted in the stagnation or decline in consumption from earnings. 'Consumption smoothing' – consuming expected future wealth today – produced its nemesis in 2008.

What needs to be done?

Ten years on is a good time to ask what policy should do to prevent the next crisis. This is what my book on Money and Government leads up to. The title was deliberately chosen. Money was at the heart of Keynes's economic theory because, as he insisted, it 'plays a part of its own'. A positive role for government in the economy was at the centre of his theory of statecraft.

In the 1930s political extremism flourished, and Keynes insisted on the political urgency of his economics: "The authoritarian state systems of today [he wrote in 1936] seem to solve the problem of unemployment at the expense of efficiency and

freedom… But it may be possible by a right analysis of the problem to cure the disease whilst preserving efficiency and freedom."

One pretty obvious conclusion from the above is that prevention is far better than cure. Once a downturn gathers momentum, the scale of intervention needed to reverse it becomes frighteningly large. Budget deficits balloon, public debts soar, governments take over banks – all conjuring up visions of looming state bankruptcy, or worse, state control over the economy. So the most important question is: how can these catastrophes be stopped from happening?

By prevention, I do not mean trying to stop the semi-regular fluctuation of 1% to 2% of nominal income over, say, a ten-year business cycle.

I mean preventing economic collapses in the order of 5% to 10% of nominal income and an unemployment rate double or treble from 'normal' times. These can happen at any time, because, as Keynes taught, the future is uncertain, and any number of unanticipated small events can have large effects.

It was the rapid spread of contagion through the banking system which brought it low in 2008. So, the question is: has the banking system been made less risky?

To some extent: capital and reserve requirements have been beefed up, big banks are now subjected to stress tests; they are required to produce 'living wills'. But the big reform has not happened: which is to cut the international links between the big banks. This is the only way to stop what is called 'contagion' spreading like wildfire across the financial system. It implies restricting the international movement of money.

This is a huge and complex matter, on which I have no special expertise to offer. But the starting point of the argument, I think, has to be to challenge the bankers' claim that global banks, by efficiently matching savers and borrowers across the globe, reduce funding costs, and so maximise global investment and growth. Banks do not allocate capital efficiently round the globe. Against this it can be claimed that banks do not allocate capital efficiently round the globe. The allocate money speculatively round the globe, producing periodic financial crashes

More fundamentally, the task of making banks resilient to shocks depends on making economies resilient to shocks. The healthier the lifestyle of an economy, the less likely it is to have a diseased banking system. An economy which can only be kept going by accumulating private debt cannot enjoy a healthy banking system.

So I would reverse the Nigel Lawson dictum: the aim of macro-economic policy should be the pursuit of growth and employment. It should do this by keeping market

economies continually closer to their production and employment possibilities than they would achieve on their own.

This requires reinserting the state into the management of the economy in two ways: by expanding the source of investment funds and by making strategic changes to the distribution of income: the twin components of Keynesian social democracy.

Governments should, through means of a Public Investment Bank, and their own capital budget, guarantee the economy a sufficient stream of new capital construction to offset the 10 speculative character of private investment, not being put off by the spurious argument that public authorities are bound to 'pick losers'. They sometimes do – and so does the private sector. The European Investment Bank is a model of what a competently run public investment bank can achieve.

A central implication of the above is that macro-economic policy cannot be 'outsourced' to central banks. They have neither the tools nor the legitimacy to do the job. The central bank mandate should simply be to support the economic policy of the government. It is for democratically accountable government to determine the trade-offs between inflation and the other objects of policy.

Governments must also take much bolder steps than any yet contemplated to reverse the concentration of wealth and income, not being put off by spurious arguments about reducing the incentives to save and work. In other words, we should set about restoring an economy whose inhabitants can 'pay their way' without having to take on more and more debt.

Other reforms are needed beyond the scope of any national authority. But the British government should at least press for the reform of the international payments system to bring pressure on trading partners to balance their current accounts, as Keynes proposed in 1941. Without such a reform, trade and currency wars will become almost inevitable.

Finally, I would emphasise Keynes's warning that bad economics produces political extremism. By bad economics I mean allowing financial markets to dictate what happens to economies. By good economics I mean recognising the duty of governments to protect their people – even the inefficient ones – against misfortune, insecurity, and calamity.

By good economics today I mean an economics which, while allowing a wide field for decentralised decision-making, insures against catastrophe, takes heed for the future, and responds to the popular demand for fairness. This was the message of Keynes. This is my message to the Labour Party.

If good politics neglects these matters, bad politics will provide its own answers.