

The Great Recession and Keynesian policies: the big test

"Indeed, the whole point of his General Theory, Keynes felt, was about preserving what was good and necessary in capitalism ... In order to preserve economic freedom in the former, which Keynes thought was essential for efficiency, increased government intervention in the latter was unavoidable. While pure free marketers might lament this development, the alternative, as Keynes saw it, was the complete destruction of capitalism and its replacement by some form of socialism." Bruce Bartlett, *The Triumph of Keynesian Economics*, chapter two *The New American Economy* (New York: Palgrave Macmillan).

Karl Marx was *"a poor thinker,"* and *Das Kapital* *"an obsolete economic textbook which I know to be not only scientifically erroneous but without interest or application for the modern world."* Bartlett op cit.

"The broad thrust of his efforts, like that of Roosevelt, was conservative; it was to ensure that the system would survive" JK Galbraith in Bartlett op cit.

Keynesian theory of crises

The Great Recession has been a real test case for the relevance of the Keynesian theory in explaining the cause of crises under capitalism; and in the efficacy of Keynesian policies in restoring sustained economic recovery.

Just as the Great Depression of the 1930s showed Keynesian theory and policies as failing and inadequate so has the Great Recession and the subsequent Long Depression that the major capitalist economies have suffered since 2009.

The explanation of crises according to Keynesian theory is 'a lack of effective demand' and the development of a liquidity trap where interest rates and the cost of borrowing stay above the 'marginal efficiency of capital', trapping liquidity that would otherwise spread into the wider economy, boost 'animal spirits' and restore domestic demand and GDP growth. The economic development of the last ten years has shown this analysis to be false.

Keynesian economic policy to restore growth has had two pillars: monetary easing to end the liquidity trap and fiscal spending to pump prime demand and boost animal spirits. Again, as in the 1930s, these policies have failed to restore previous trend growth and average incomes.

This paper will attempt to explain why.

For orthodox Keynesians, crisis come about because of a collapse in aggregate or effective demand in the economy (as expressed in a fall of investment and consumption). This fall in investment leads to a fall in employment and thus to less income. Effective demand is the independent variable and incomes and employment are the dependent variables. There is no mention of profit or profitability in this schema. Investment creates profits not vice versa. This is the view of Keynes: *"Nothing obviously, can restore employment which does not first restore business profits. Yet nothing, in my judgement, can restore business profits that does not first restore the volume of investment."* (*Collected Writing Vol 13, p343*).

But if investment is the independent variable, according to Keynes, what causes a fall in investment? It is an ending of 'animal spirits' among entrepreneurs or a 'lack of confidence'. As Minsky, a devoted follower of Keynes, put it, investment is dependent on *"the subjective nature of expectations about the future course of investment, as well as the subjective determination of bankers and their business clients of the appropriate liability structure for the financing of positions in different types of capital assets"*. So profits depend on expectations and crises are the result of changed expectations by financial speculators. Investment and credit grow as long as there is confidence: what others have called 'magic Tinkerbell fairy dust', a belief that things will only get better.

Yet, unlike his followers, Keynes understood completely the central role of profit in the capitalist system. This is one reason why he was so strongly opposed to deflation and why, at the end of the day, his cure for unemployment was to restore profits to employers. He also appreciated the importance of entrepreneurship, which he called *"animal spirits"*: *"If the animal spirits are dimmed and the spontaneous optimism falters...enterprise will fade and die."* And he knew that the general business environment was critical for growth; hence business confidence was an important economic factor.

As Keynes acknowledged, *"Economic prosperity is...dependent on a political and social atmosphere which is congenial to the average businessman."* *"Unemployment, I must repeat, exists because employers have been deprived of profit. The loss of profit may be due to all sorts of causes. But, short of going over to Communism, there is no possible means of curing unemployment except by restoring to employers a proper margin of profit."*~ John Maynard Keynes, "Proposals for a Revenue Tariff," *The New Statesman and Nation* (March 7, 1931), reprinted in *Essays in Persuasion*. ‘

But this insight of Keynes is completely forgotten by modern Keynesians. Take Paul Krugman, the guru of Keynesian ideas now. In his book, End Depression now, written just after the end of the Great Recession in 2010, Krugman reckons what was wrong was that: *"we are suffering from severe lack of overall demand"*. Krugman uses the example of a baby coop scheme. At a certain point, instead of people spending their coupons on babysitting services, they start to save them up. Similarly, instead of businesses investing their money or households spending, they start saving for some unknown subjective, irrational reason, and that is what creates the lack of demand. *"Collectively, world residents are trying to buy less stuff than they are capable of producing to spend less than they earn. That's possible for an individual but not for the world around us. And the result is the devastation around us"*.

Similarly, Joseph Stiglitz, reckoned in 2009 that *"The lack of global aggregate demand is, in a sense, one of the fundamental problems underlying this crisis. Lack of aggregate demand was the problem with the Great Depression, just as lack of aggregate demand is the problem today."*

But to say the cause of the Great Recession was due to a lack of demand is bit like saying that that the cause of the streets being wet today is because it is raining today. That tells us nothing about why it is raining today and/or what causes rain to happen. Describing the Great Recession as a lack of demand is just that, a description, not an explanation.

The Keynesians look at 'effective demand' because they have a cockeyed view of the capitalist economy. Keynesians do not start with a theory of value (i.e. where income comes from in an economy). For them, the only value is money. Money must be spent to provide 'effective demand'

in an economy. Thus, investment and consumption demand delivers incomes (profits and wages) not vice versa, as Marxist (and classical) economics argues.

This brings me to the profit equation developed by Michel Kalecki, a Polish economist and synthesiser of Marx and Keynes. His equation is simply that Profits = Investment; or more importantly, profits depend on investment.

National income = national expenditure – that's easy.

National income can then be broken down to Profit + Wages; and National expenditure can be broken down to Investment + Consumption.

So Profit + Wages = Investment + Consumption.

Now if we assume that wages are all spent on consumption and not saved, then

Profits = Investment.

So far, so good.

But here is the rub. This identity does not tell us the causal direction that can help us develop a theory. For Keynes, the causal direction is simply that investment creates profit. But what causes investment? Well, the subjective decisions of individual entrepreneurs. What influences their decisions? Well, 'animal spirits', or varying expectations of a return on investment etc. Already we are back into the subjective approach of the neoclassical school.

As a recent paper (James Montier, *What goes up must come down!*, March 2012) supporting Kalecki put it succinctly: "*This is, of course, an identity – a truism by construction. However it can be interpreted with some causality imposed. After all, profits are a residual: they are remainder after the factors of production have been paid.*" Really? That's neoclassical theory. Montier goes on: "*Investment drives profits because when a firm or a household decides to invest in some real asset they are effectively buying a good from another firm, creating profits for that entity.*" So it seems that profits come from buying things (consumption) and not from surplus value created in the labour process, as Marx argued.

This argument is spelt out even more explicitly in a 2008 paper, *Where profits come from*, by David Levy, Martin Farnham and Samira Ryan at the Jerome Levy Forecasting Center. The authors state that the profits equation identifies the "*sources of profits = investment, non-business saving (households), dividends and profit taxes.*" How taxes on profits can be a 'source' of profit is beyond me. Or how dividends can be a 'source' of profit rather than a part of profit is also weird. Take these out and assume workers don't save and we are back to the 'source' of profit as investment.

But following the Kalecki equation further: Profits = Investment – (non-capitalist) Savings. Savings can be divided into three parts: savings by households, saving by governments and foreign capitalist savings. If households save more (as they tend to do in a slump) and foreign savings rises (in other words the national economy's deficit with the rest of the world rises), then investment will be lower and so will profits. However, there is a saviour: government savings, or to be more exact; government dissaving. If government runs up a big budget deficit, in other words, dissaves, it can boost investment and thus profits.

Indeed, currently, in the US, using the Kalecki profits equation, it would appear that profits depend on government dissaving or net borrowing. Without it, profits would fall. So the last

thing that capitalism should do is cut government spending. The Keynes-Kalecki profits equations tells us that capitalism can be saved by more government spending, not less.

The idea that profits depend on investment is back to front. For Marxists, it is the other way round: investment depends on profit. And profit depends on the exploitation of labour power and its appropriation by capital. Thus we have an objective causal analysis based on a specific form of class society, not based on some mystical psychoanalysis of individual human behaviour. The Keynesian causal direction leads to a cockeyed understanding of the laws of motion of capitalism.

So what if we turn the causal direction the other way: the Marxist way. Now investment in an economy depends on profits. If profits are fixed in the equation and cannot be increased, then investment cannot be increased. So capitalist investment (i.e investment for a profit) will now depend on reducing the siphoning off of profits into capitalist consumption and/or on restricting non-capitalist investment, namely government investment. So capitalism needs more government saving, not more dissaving. Indeed, it is the opposite of the Keynesian policy conclusion. Government borrowing will not boost profits, but the opposite – and profits are what matters under capitalism. So government is a negative for capitalist investment.

Government spending will not boost the capitalist economy because it eats into profitability by depriving the capitalist sector of some of its potential profit. Kalecki sort of realised this in his famous paper, *Political aspects of full employment*, 1943, when he said: "*public investment should be confined to objects that don't compete with the equipment of private business. Otherwise, the profitability of private investment might be impaired and the effect of public investment upon employment offset by the negative effect of the decline in private investment*".

Guglielmo Carchedi presents the difference I have described here as between the Keynesian multiplier (i.e. consumption to investment to national income to profits) and the Marxist multiplier (i.e. profits to investment to income and consumption). Remember the multiplier is a device invented by Richard Kahn, Keynes' disciple of the 1930s. It purports to measure the change in real GDP caused by a change in government spending or taxation – in other words the impact on growth of government fiscal measures.

Carchedi: "*In the Keynesian multiplier, state induced investments have a positive effect on production and thus on income, spending, and saving.....Profitability plays a subordinate role and the effects on the economy are always apparently positive. In the Marxist multiplier, profitability is central.... The question is whether n rounds of subsequent investments generate a rate of profit higher than, lower than, or equal to the original average rate of profit*".

Keynesians see the capitalist economy in a utopian way. The Keynesian analysis denies or ignores the class nature of the capitalist economy and the law of value under which it operates by creating profits from the exploitation of labour. As a result, Keynesian macro identities start from consumption and investment ("effective demand") and go onto incomes and employment. So the Keynesian multiplier measures the impact of more or less spending (demand) on income (GDP). BUT it does not measure the impact on profitability. And that is crucial to growth under the capitalist mode of production.

That brings me to the second proposition that Keynesians want to draw from the fiscal multiplier: that we need more fiscal stimulus. A Marxist critique of Keynesian stimulus and government

investment is not meant to imply opposition to reversing the austerity cuts or boosting government spending, especially investment in infrastructure and other job-creating areas.

The Marxist critique of fiscal multipliers is that the Keynesian solution is utopian because bigger government and more spending leads to lower profitability in the capitalist sector and it leads to an encroachment on the interests of the capitalist sector.

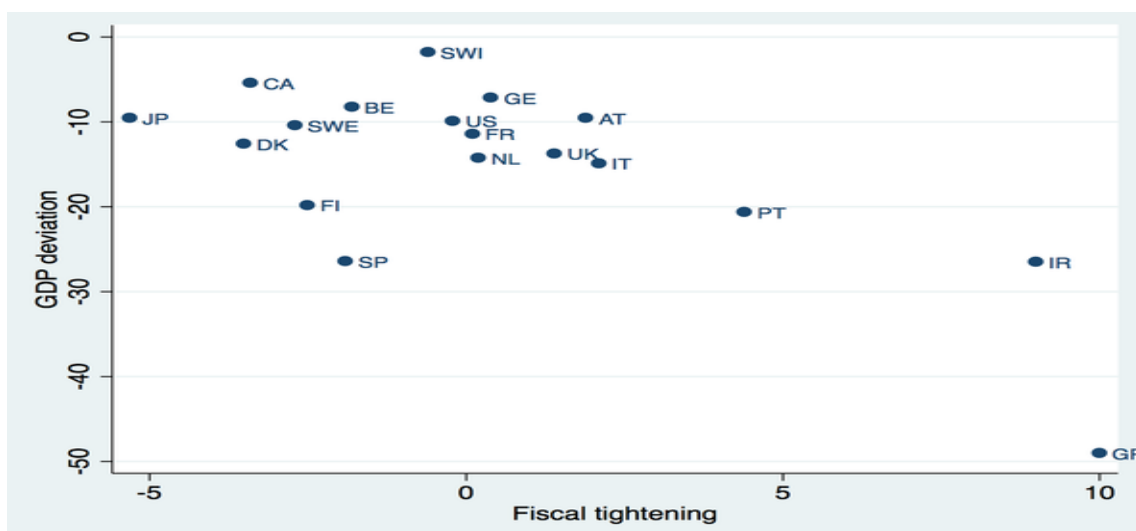
If the Marxist multiplier is the right way to view the modern economy, then what follows is that government spending and tax increases or cuts must be viewed from whether they boost or reduce profitability. If they do not raise profitability or even reduce it, then any short-term boost to GDP from more government spending will only be at the expense of a lengthier period of low growth and an eventual return to recession. There is no assurance that more spending means more profits – on the contrary. Government investment in infrastructure may boost profitability for those capitalist sectors getting the contracts, but if it is paid for by higher taxes on profits, there is no gain overall. And if it is financed by borrowing, profitability will eventually be constrained by a rising cost of capital.

The Keynesian versus the Marxist multiplier

Recently, Paul Krugman considered the impact of fiscal tightening, as measured by the IMF's estimate of the cyclically adjusted primary balance (i.e., excluding interest payments) as a percentage of GDP.¹ He showed the not the raw change in GDP, but the deviation of real GDP from what the IMF was projecting before the crisis and assumed that projected growth 2007-2013 was expected to continue for two more years to get 2015 estimates. This appears to show a significant correlation between fiscal tightening as defined and the deviation of actual real GDP growth from the IMF forecast.

The deviation from the pre-crisis IMF real GDP growth forecast and fiscal tightening (cyclically adjusted primary balance as a % of GDP).

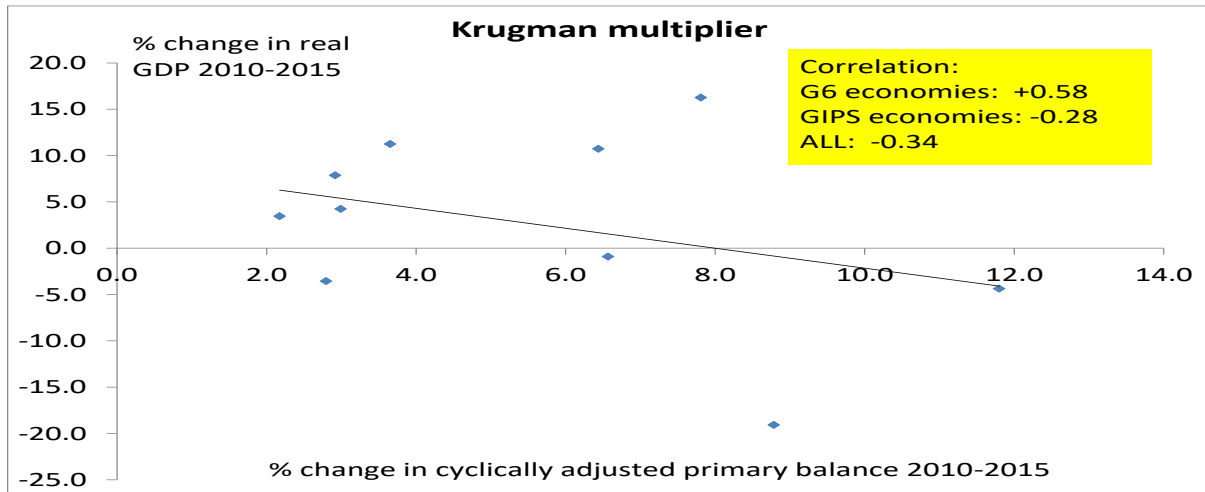
Source: Paul Krugman



However, as Krugman says himself, this is perhaps an odd way of measuring the impact of the Keynesian multiplier and, if Greece is excluded, the correlation is less convincing. If instead of the

deviation from IMF pre-crisis GDP forecasts, we use the change in the real GDP in the last five years against fiscal tightening, as defined by Krugman, the result does show a negative correlation for the G6 plus distressed Eurozone economies between 2010 and 2015. But interestingly, there is positive correlation for the G6 alone. In other words, the tighter the fiscal impact, the better the GDP pick-up in the G6 economies – the opposite of the conclusions of the Keynesian multiplier.

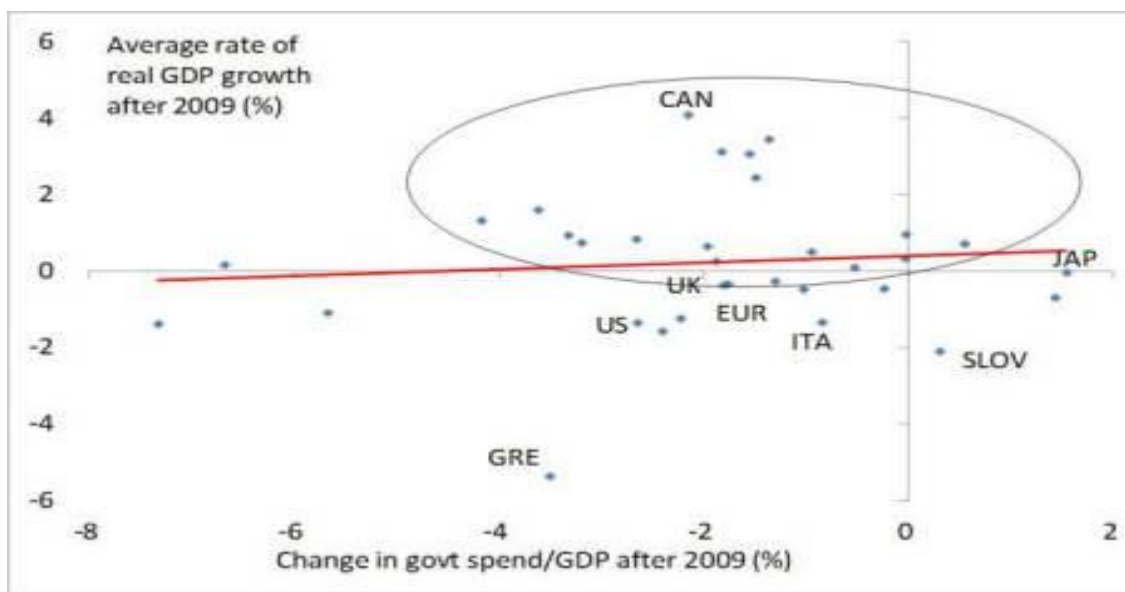
Changes in real GDP and the cyclically adjusted primary balance as % of GDP, 2010-15.



If we compare changes in government spending to GDP against the average rate of real GDP growth since 2009 for the OECD economies, there is a very weak positive correlation and none if Greece is removed (Figure 15).

Figure 15. The average rate of real GDP growth since 2009 (%) in the OECD economies and the change in government spending to GDP (%).

Source: AMECO database, author’s calculations



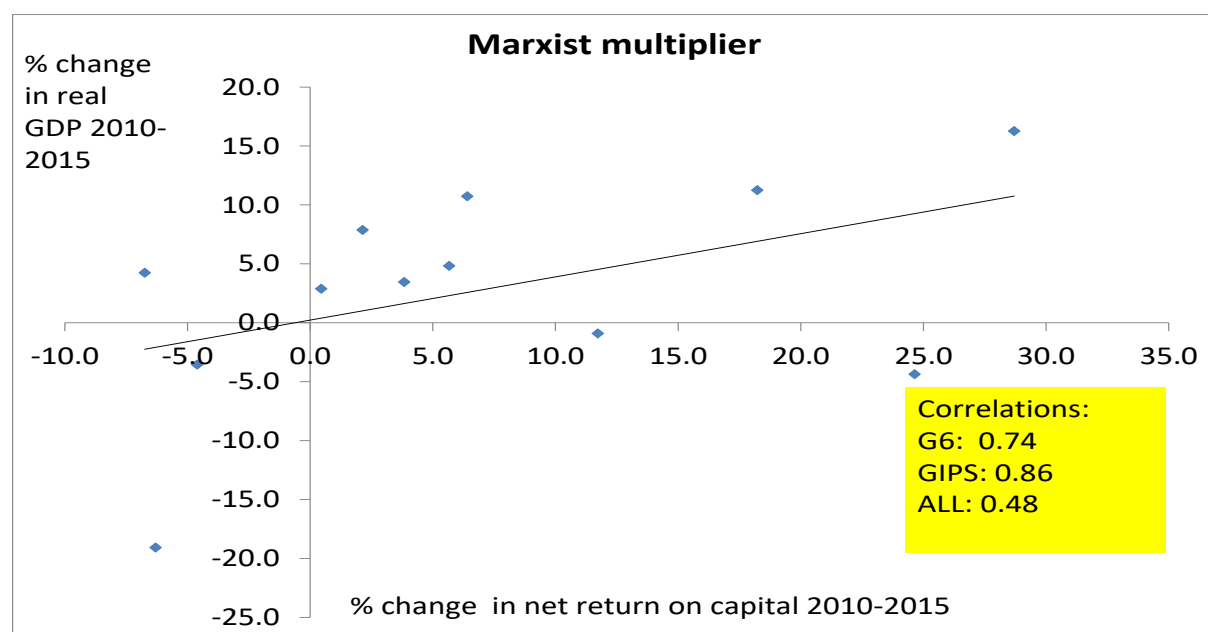
Also in a new study of the impact of austerity on growth, Alberto Alesina and Francesco Giavassi found that *“fiscal adjustments based upon cuts in spending are much less costly, in terms of output*

losses, than those based upon tax increases.spending-based adjustments generate very small recessions, with an impact on output growth not significantly different from zero.” And “Our findings seem to hold for fiscal adjustments both before and after the financial crisis. We cannot reject the hypothesis that the effects of the fiscal adjustments, especially in Europe in 2009-13, were indistinguishable from previous ones”. In other words, cutting government spending (austerity) had little effect on the real GDP growth rate and that applied to the post-crisis ‘austerity’ policies of European governments.ⁱⁱ

Again in a new paper, Cugnasca and Rother from the EU Commission find that the average output cost of a fiscal adjustment equal to 1% of GDP is 0.5% of GDP for the EU as a whole in line with the size of multipliers assumed before the crisis, despite the fact that approximately three quarters of the consolidation episodes that considered occurred after 2009. The multiplier is somewhat larger at 0.76 for Eurozone countries and EU countries with a currency pegged to the euro, where monetary policy is less able to compensate for country-specific adjustments.ⁱⁱⁱ

Now let’s consider the impact of changes in the profitability of business capital against economic growth (the Marxist multiplier). There is a significant positive correlation between changes in profitability of capital and economic growth.

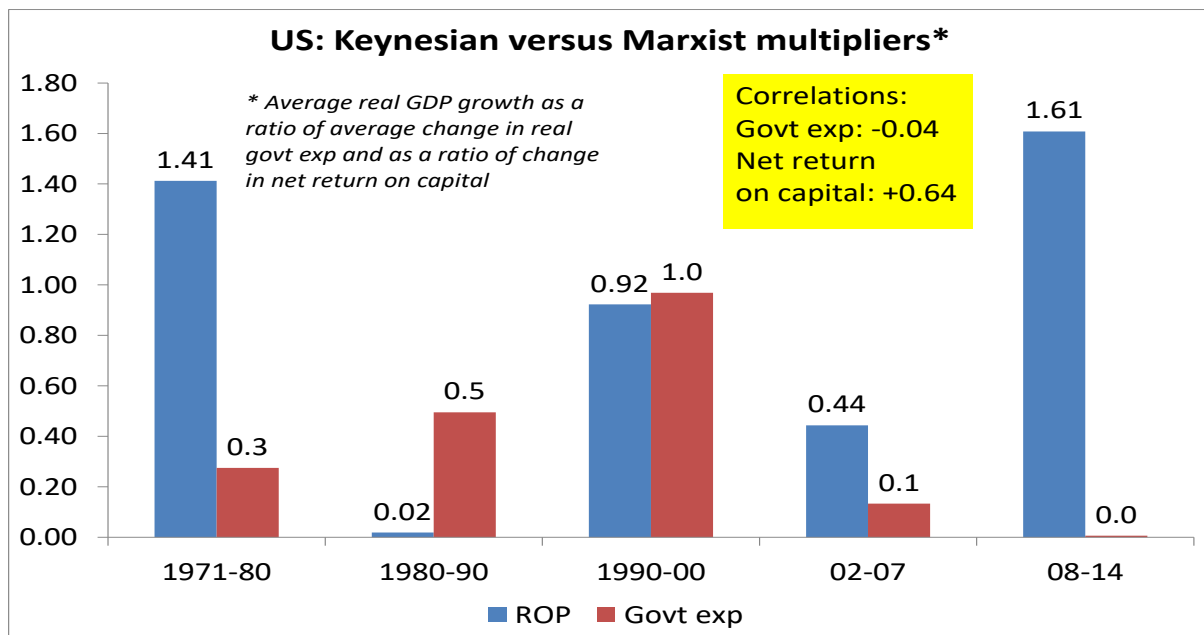
The Marxist multiplier: change in real GDP and change in net return on capital, %, 2010-25.



The correlations are positive for G6 plus the distressed Eurozone economies (GIPS) and at much higher levels than with the Keynesian multiplier. We find that real GDP growth is strongly correlated with changes in the profitability of capital, while the correlation is only slightly negative with changes in government spending.

Average real GDP growth as a ratio of the average change in real government spending and the net return on capital.

Source: AMECO database, author’s calculations



This suggests that it is the profitability of capital that is decisive for the recovery or otherwise from an economic recession or depression.

But let us accept, for the moment, that a lack of aggregate demand is the cause of crises and slumps. What policies can be employed to end this? Clearly ones that increase aggregate demand. There are two pillars of policy for this: monetary easing and government spending.

British Keynesian guru, Simon Wren-Lewis spells out the supposed impact of monetary easing. "Here it is helpful to go through the textbook story of how a large negative demand shock should impact the global economy. Lower demand lowers output and employment. Workers cut wages, and firms follow with price cuts. The fall in inflation leads the central bank to cut real interest rates, which restores demand, employment and output to its pre-recession trend."

In his [Treatise on Money](#) written in 1930 at the start of the Great Depression, Keynes argued that central banks would have to intervene with what we now call 'unconventional monetary policies' designed to lower the cost of borrowing and raise sufficient liquidity for investment. Just trying to get the official interest rate down would not be enough. As a recent paper from the Levy Institute put it: "In the penultimate chapter of volume 2 of the *Treatise*, Keynes raises the question of the ability of the monetary authority to influence the price level...despite his doubts, Keynes nonetheless answers his own question in the affirmative, urging central bankers to adopt extraordinary, unorthodox measures in an attempt to counter the deepening recession." Keynes proposed: "My remedy in the event of the obstinate persistence of the slump would consist, therefore, in the purchase of securities by the central bank until the long-term market rate of interest has been brought down to the limiting point, which we shall have to admit a few paragraphs further on. It should not be beyond the power of a central bank (international complications apart) to bring down the long-term market-rate of interest to any figure at which it is itself prepared to buy long-term securities."

In the *Treatise*, Keynes was convinced that such measures of buying government bonds and boosting fiat money quantity rather than just trying to lower the price of short term money would be

effective “Thus I see small reason to doubt that the central bank can produce a large effect on the cost of raising new resources for long-term investment, if it is prepared to persist with its open market policy far enough.” This would work because it would increase ‘liquidity’ in the banking system and it would also raise ‘confidence’ (that ‘fairy dust’ of modern economics) by convincing investors that the low cost of borrowing was here to stay.

Well, was Keynes (followed by quantity of money theorist Milton Friedman and the modern monetarists like Bernanke and Woodford) right? Did QE restore investment and economic growth through increased ‘liquidity’ in the banking system and by raising ‘confidence and expectations’? Clearly not. The Bank of Japan adopted such measures through the 1990s with little success in restoring investment and economic growth. The QE adopted by the Fed, the BoE, the BoJ and, more recently, the ECB, may have put huge amounts of cash into the banks and inspired speculation into ‘higher-yielding’ assets like bonds and stocks, and even boosted the cash hoards on large non-financial firms, but it has not restored business investment and economic growth to pre-crash levels.

As Susan de Brunhoff explained, Marx’s theory of money argues that there are three functions of money: as a means of payment or circulation; as a measure of value; and as a store of value. A monetary economy provides the possibility of hoarding, taking money out of circulation to preserve its value. In a slump or crash, capitalists try to hoard and avoid investment. If profitability stays low, then even a low rate of interest or mountains of ‘liquidity’ will not release that hoard, or the ‘liquidity trap’, as Keynes called it. You can lead a horse to water, but you cannot make it drink. So no matter how much cash the central bank pumps in by buying government or even corporate securities, investment does not recover. It’s like pushing on a string. Such was the argument of Marx against the quantity on money theorists during the banking crisis of the 1840s.

By 1936 after five more years of depression (similar to the time post the Great Recession now), Keynes became less convinced that ‘unconventional monetary policies’ would work. In his famous General Theory of Employment, Interest and Money (GT), Keynes moved on.

As the Levy Institute paper notes: “What has not been borne out is the expected impact on the rate of investment. Businesses have indeed increased their borrowing, and the spread between corporate junk bonds has fallen to near-historic lows as companies seek to borrow at historically low interest rates. However, these funds are not being used to finance new investment. Similarly, banks have accumulated record levels of reserves in their deposit accounts at the Fed, earning the short-term interest rate, which is nearly zero. Thus, the policy has been successful in influencing the interest rate in the way Keynes predicted, but it has not had the impact on investment that he outlined in the Treatise.”

Why did the policy of QE fail, according to Keynes? The problem was that “The state of confidence . . . is a matter to which practical men always pay the closest and most anxious attention... because of its important influence on the schedule of the marginal efficiency of capital. There are not two separate factors affecting the rate of investment, namely, the schedule of the marginal efficiency of

capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former” (p148–49). Thus, “there is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable. “

So low interest rates and extra liquidity cannot get things going again, if the profitability of investment (what Keynes calls the ‘marginal efficiency of capital’) remains too low. Keynes concluded in the GT: *“I am now somewhat sceptical of the success of a merely monetary policy directed towards influencing the rate of interest. I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment; since it seems likely that the fluctuations in the market estimation of the marginal efficiency of different types of capital, calculated on the principles I have described above, will be too great to be offset by any practicable changes in the rate of interest”*. And so Keynes moved on to advocating fiscal spending and state intervention to complement or pump-prime failing business investment.

Many Keynesians are still wedded to QE, however. It is just that not enough QE has been done. We need to consider [negative interest rates and ‘helicopter money’](#), named after the idea that the central bank should just drop cash from helicopters to people below to spend – the modern version would be to credit every household bank account with a few thousand dollars. The [People’s QE](#), advocated by some advising the new left-wing leaders of the British Labour party, is a variant of this approach. You might think these measures would work. But if you got \$1000 suddenly in your bank account, would you spend it or instead save it for a rainy day or pay down some outstanding debt? It’s not clear that ‘helicopter money’ would do the trick in boosting ‘demand’ and thus growth.

As [Stephen Cecchetti has pointed out](#), these ‘extreme’ QE measures are really forms of fiscal spending as the government must be prepared to bail out the central bank if the helicopter money is not spent and never seen again. Funding banks to invest in the productive sector has gained some traction with the new EU infrastructure fund or the proposed [National Investment Bank by the British Labour leaders](#).

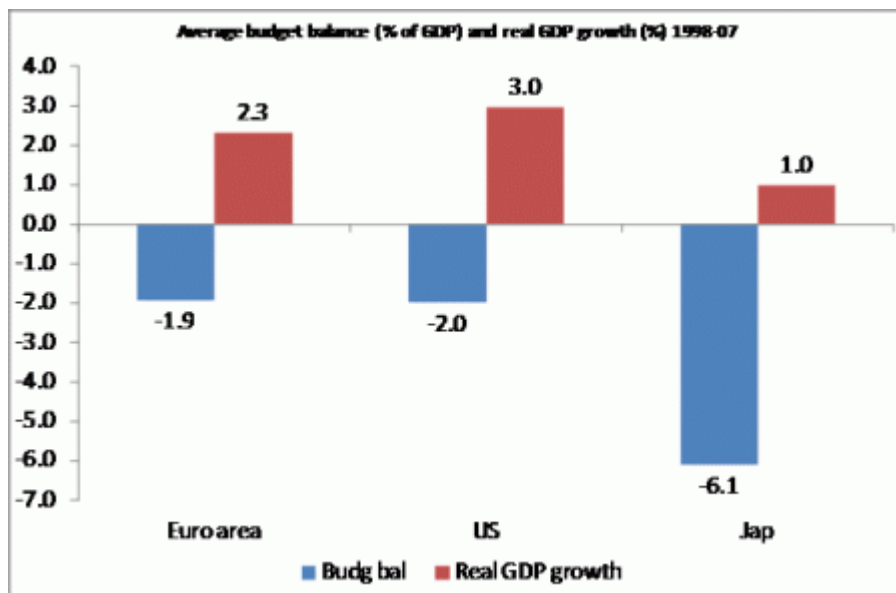
The Keynes of the GT was classic or ‘old Keynesianism’ that was dominant in the post-war period. But with the failure of ‘old Keynesian’ macro-management in the 1970s (with stagflation), there was a morphing into ‘new Keynesianism’ and back to the efficacy of monetary policy, as in the Treatise. The ‘old Keynesian’ style fiscal spending is now mainly ignored or dismissed by mainstream economists as lacking credibility. But some ‘old-style’ Keynesians continue to press for running budget deficits and borrowing more to do the trick.

But will fiscal spending work? The example of Japan shows otherwise.

I did a little piece of statistical research on this issue comparing the average budget deficit to GDP for Japan, the US and the Euro area against real GDP growth since 1998. 1998 is the date that most economists argue was the point when the Japanese authorities went

for broke with Keynesian-type government spending policies designed to restore economic growth. Did it work?

Well, between 1998 and 2007, Japan's average budget deficit was 6.9% of GDP, while real GDP growth averaged just 1%. In the same period, the US budget deficit was just 2% of GDP, less than one-third of that of Japan, but real GDP growth was 3% a year, or three times as fast as Japan. In the Euro area, the budget deficit was even lower at 1.9% of GDP, but real GDP growth still averaged 2.3% a year, or more than twice that of Japan. So the Keynesian multiplier did not seem to do its job in Japan over a ten-year period. Again, in the credit boom period of 2002-07, Japan's average real GDP growth was the lowest even though its budget deficit was way higher than the US or the Eurozone.



Now let's look at the period from the point of view of the Marxist multiplier. As I have shown in many previous posts, after 1997, the rate of profit in most of the advanced capitalist world began to decline. The Marxist multiplier would then forecast that investment growth would start to slow, and so would GDP growth. Well, in the four years from 1998 to the mild recession of 2001, US real investment growth averaged 6.1% a year while the government ran a small budget surplus and real GDP growth was 3.6% a year. But after the recession of 2001, during the credit boom of 2002-07, US real investment growth slowed to 2.2% a year, but the government ran a budget deficit that averaged 3.6% of GDP and real GDP growth slowed to 2.6% a year. It was the same story for Europe. Even more

revealing is capitalist investment in the productive sectors of the economy (real non-residential private capital formation in OECD terms). Between 1998-01, US real investment in productive sectors rose 7.2% a year, but from 2001-07 it rose only 3.5% a year (half the rate). Again it was the same story for Europe.

There does not seem to be any evidence that bigger government spending or wider budget deficits will lead to faster investment or economic growth over time in capitalist economies. Indeed, the evidence is to the contrary much of time. The Marxist multiplier of profitability and investment seems more convincing.

There is a new radical think-tank that has just kicked off in the UK. It's got a great name: Class: the Centre for Labour and Social Studies. Sounds socialist, even Marxist, yes? Unfortunately, at its first meeting, the speakers, especially the economists, were all Keynesian to a man and woman. Take the main paper at the conference: *Fiscal austerity: the cure which makes the patient worse*, by Professor Malcolm Sawyer <http://classonline.org.uk/pubs/item/fiscal-austerity-the-cure-which-makes-the-patient-worse-full-paper>. All the Keynesian arguments are presented against austerity. Apparently, a Marxist analysis and the role of profit has no contribution to make in explaining the Great Recession and the ensuing long depression and, above all, what to do about it.

But can more government spending take the capitalist economies of the US, Europe and Japan out of this long depression? if we assume that the capitalist mode of production is to remain dominant and state-controlled production will not replace the private sector, then more government spending will only succeed in ending the long depression if it raises the

The irony is that Keynes knew this and recognised that only by cutting real wages and boosting profits could the depression end. Capitalists can't very well cut prices unless their costs also fall and labor is the largest expense for any business." Keynes originally thought along the same lines as mainstream neoclassical economists. As he said in 1925: "Our (whose?) problem is to reduce money wages and, through them, the cost of living, with the idea that, when the circle is complete, real wages will be as high, or nearly as high, as before.... The object of credit restriction, in such a case, is to withdraw from employers the financial means to employ labor at the existing level of prices and wages. The policy can only attain its end by intensifying unemployment without limit, until the workers are ready to accept the necessary reduction of money wages under the pressure of hard facts."

But in 1926 a massive general strike against wage cuts convinced Keynes that offsetting an inflation with a deflation as a means to maintain average price stability was no longer a viable option. Since workers would strenuously resist the wage cuts that were a necessary consequence of a deflation, British businesses would be compelled by market forces to cut prices yet be stuck with high labor costs that would cripple them. As Keynes explained to an American audience in a 1931 lecture: "Will not the social resistance to a drastic downward readjustment of salaries and wages be an ugly and dangerous thing? I know that in my own country a really large cut of many ages, a cut at all of the same magnitude as the fall in wholesale prices, is simply an impossibility. To attempt it would be to

shake the social order to its foundation. There is scarcely one responsible person in Great Britain prepared to recommend it openly.”

So, instead of forcing wages and prices to adjust to a monetary deflation, Keynes thought it made much more sense to readjust the currency. Better to raise prices back up to where they were previously than endure the pain of vast unemployment and huge wage cuts, he argued. This would restore equilibrium without the necessity of reducing wages by the same percentage that the price level had fallen. As Keynes put it, “*The cumulative argument for wishing prices to rise appears to me...to be overwhelming.*”¹⁹

In the *General Theory of Employment, Interest and Money*, the basic argument was that it was impractical to reduce unemployment by forcing down money wages to adjust for a monetary deflation.²³ It was vastly preferable, Keynes explained, to simply reduce real (inflation-adjusted) wages by offsetting the deflation with a compensating inflation. As he put it early in the book: “Whilst workers will usually resist a reduction of money-wages, it is not their practice to withdraw their labor whenever there is a rise in the price of wage goods. It is sometimes said that it would be illogical for labor to resist a reduction of money-wages but not to resist a reduction of real wages.... But, whether logical or illogical, experience shows that this is how labor in fact behaves.”²⁴

Further on Keynes was even more explicit about using inflation to reduce real wages in order to raise employment. “A movement by employers to revise money-wage bargains downward will be much more strongly resisted than a gradual and automatic lowering of real wages as a result of rising prices,” he wrote.²⁵ Keynes’s argument basically boiled down to practicality. “A flexible wage policy and a flexible money policy come, analytically, to the same thing,” he explained, “inasmuch as they are alternative means of changing the quantity of money in terms of wage-units.” Keynes conceded that governments could theoretically force down wage rates by decree but that only authoritarian states had such power. Every nation, however, had the power to alter the value of its currency and thus the price level through monetary policy. As he put it: “When this happens, open market operations by the central bank, which involves buying bonds and paying for them with newly created money, become impotent. It would simply be exchanging one asset for another that is virtually identical because money is really just a perpetual bond that pays no interest.”²⁷

Getting the money moving, so to speak, requires the government to engage in deficit financing precisely for the purpose of increasing market interest rates, which would get the economy out of the liquidity trap and make an expansive monetary policy effective once again. It didn’t really matter what the money raised by borrowing was spent on as long as it involved the purchase of goods and services. Income transfers and tax cuts were less effective because much of the money would be saved, thus frustrating the need to raise interest rates. It would be best for governments to finance the construction of socially beneficial public works, such as roads and buildings.²⁸ But for macroeconomic purposes it was not necessary that the construction be inherently productive, because the primary purpose of the effort was to create a mechanism for making monetary policy effective.

Toward this end, Keynes suggested that pyramid-building, earthquakes, and even wars might serve an economically useful purpose when the economy was stuck in a liquidity trap, because they forced governments to spend funds rapidly and run deficits. He jokingly proposed that governments might even bury cash in old mine shafts that had been filled with rubbish.

Keynes had two basic motivations. One was to destroy the labor unions and the other was to maintain the free market. Keynes despised the American Keynesians. His whole idea was to have an impotent government that would do nothing but, through tax and spending policies, maintain the equilibrium of the free market.

Keynes was always deeply conservative.⁵⁶ He valued institutions which had historic roots in the country; he was a great upholder of the virtues of the middle-class which, in his view, had been responsible for all the good things that we now enjoy; he believed in the supreme value of intellectual leadership, in the wisdom of the chosen few; he was interested in showing how narrow was the circle of kinship from which the great British leaders in statesmanship and thinking had been drawn; and he was an intense lover of his country.... He was not a Socialist. His regard for the middleclass, for artists, scientists and brain workers of all kinds made him dislike the class-conscious elements of Socialism. He had no egalitarian sentiment; if he wanted to improve the lot of the poor...that was not for the sake of equality, but in order to make their lives happier and better.... He did not think it would be ⁵⁵

State Socialism to be quite obsolete.⁵⁷ As Keynes himself explained, “the class war will find me on the side of the educated bourgeoisie.” Conservative icon Edmund Burke was one of his political heroes. Keynes expressed contempt for the British Labor Party, calling its members “sectaries of an outworn creed mumbling moss-grown demi-semi Fabian Marxism.” He also termed the British Labor Party an “immense destructive force” that responded to “anti-communist rubbish with anticapitalist rubbish.”⁵⁸ Keynes was one of socialism’s greatest enemies, even if some on the right still view Keynes as a cryptocommunist.⁵⁹ State socialism, he said, “is, in fact, little better than a dusty survival of a plan to meet the problems of fifty years ago, based on a misunderstanding of what someone said a hundred years ago.”

Toward the end of his life Keynes even wrote to F.A. Hayek in praise of his book, **The Road to Serfdom (1944)**, which argues that economic planning inevitably leads to totalitarianism. **As** Keynes told Hayek in a personal letter, “morally and philosophically I find myself in agreement with virtually the whole of it; and not only in agreement with it, but in a deeply moved agreement.”

Keynes wrote in his very last published article, “I find myself moved, not for the first time, to remind contemporary economists that the classical teaching embodied some permanent truths of great significance. . . . There are in these matters deep undercurrents at work, natural forces, one can call them or even the invisible hand, which are operating towards equilibrium. If it were not so, we could not have got on even so well as we have for many decades past.”¹⁴

The only way to revive that profitability is through slumps that destroy the value of accumulated capital, so that profitability (relative to remaining value) will then rise and allow the process of accumulation to resume. Just more government spending designed to ‘stimulate’ the private sector will not do the trick. Only the replacement of capitalist accumulation with state-planned investment as the dominant mode of production would do so. Otherwise, we can expect another slump down the road.

ⁱ <http://krugman.blogs.nytimes.com/2015/11/28/demand-supply-and-macroeconomic-models/>

ⁱⁱ Alberto Alesina and Francesco Giavazzi, NBER Reporter 2015 Number 3: Research Summary, The Effects of Austerity: Recent Research

ⁱⁱⁱ Cugnasca, A, P Rother (2015), "Fiscal multipliers during consolidation: evidence from the European Union", Working Paper Series 1863, European Central Bank.
<http://www.voxeu.org/article/fiscal-multipliers-during-consolidation-evidence-european-union>

SOURCES AND METHODOLOGY FOR FIGURES

Figure 1. author

Figure 2. Datastream for real GDP growth, excel macro for exponential trend GDP growth

Figure 3. FT-Brookings

Figure 4. World Bank World Bank,
www.worldbank.org/content/dam/Worldbank/GEP/GEP2015a/pdfs/GEP15a_web_full.pdf

Figure 5. IMF, <http://blog-imfdirect.imf.org/2015/04/28/close-but-not-there-yet-getting-to-full-employment-in-the-united-states>

Figure 6. Wall Street Journal

Figure 7. Datastream for personal consumption expenditures and gross private fixed investment and current GDP. Data lagged back one year (t-1) from point of start of each recession.

Figure 8. Graph adapted by author from work of Esteban Maito, 2014, "The Historical Transience of Capital", <http://gesd.free.fr/maito14.pdf>

Figure 9. Data and methodology in Carchedi, Guglielmo, and Michael Roberts, 2013b, "The Long Roots of the Present Crisis: Keynesians, Austerians and Marx's Law", *World Review of Political Economy*, volume 4, number 1, <http://gesd.free.fr/robcarch13.pdf>

Figure 10. Federal Reserve (FRED series), TNWMVBSNNCB and CRDQUSANABIS

Figure 11. Data and methodology from Carchedi and Roberts op cit

Figure 12. S.P. Kothari, Jonathan Lewellen, Jerold B. Warner The behavior of aggregate corporate , August 2015

Figure 13. <http://krugman.blogs.nytimes.com/2015/11/28/demand-supply-and-macroeconomic-models/>

Figure 14. AMECO database:

Net returns on net capital stock: total economy (APNDK)

Gross domestic product at 2010 reference levels (OVGD)

Net lending (+) or net borrowing (-) excluding interest: general government :- ESA 2010 (UBLGI)

% changes 2010-15 correlated

Figure 15. AMECO database

Net returns on net capital stock: total economy (APNDK)
Gross domestic product at 2010 reference levels (OVGD)
% changes 2010-15 correlated

Figure 16. AMECO database

Net returns on net capital stock: total economy (APNDK)
Total expenditure: general government :- ESA 2010 (Including one-off proceeds (treated as negative expenditure) relative to the allocation of mobile phone licences (UMTS)) (UUTG)
Gross domestic product at 2010 market prices (OVGD)
Real total expenditure of general government, deflator GDP :- ESA 2010 (OUTG)
Ratio of changes in GDP to govt exp and net return on capital from 1971

Figure 17. Datastream

Corporate profits from US, UK, Japan, Eurozone and China, % yoy changes averaged.

Figure 18. Datastream

US CORPORATE PROFITS WITH IVA & CCADJ - TOTAL (AR) CURA

All working data in excel for those figures prepared by the author are available on request.

References

Carchedi, Guglielmo, 2012, "Could Keynes End the Slump? Introducing the Marxist Multiplier", *International Socialism* 136 (autumn), <http://isj.org.uk/could-keynes-end-the-slump-introducing-the-marxist-multiplier>

Carchedi, Guglielmo, and Michael Roberts, 2013a, "Marx's Law of Profitability: Answering Old and New Misconceptions", *Critique*, volume 41, issue 4.

Carchedi, Guglielmo, and Michael Roberts, 2013b, "The Long Roots of the Present Crisis: Keynesians, Austerians and Marx's Law", *World Review of Political Economy*, volume 4, number 1, <http://gesd.free.fr/robcarch13.pdf>

Daly, Mary C, and Bart Hobijn, 2015, "Why Is Wage Growth So Slow?", Federal Reserve Bank of San Francisco Economic Letter (5 January), <http://tinyurl.com/np8uf6j>

Davies, Gavyn, 2015, "Demand Side Gains for the Global Economy in 2015", *Financial Times* (4 January), <http://tinyurl.com/nmjvup8>

Dolan, Ed, 2015, "Did Austerity Work in Britain? One Chart Tells It All" (8 April), <http://tinyurl.com/oavoo5o>

Furnam, Jason, 2014, "The Global Economy: Demand, Supply and Interdependence" (Council of Economic Advisers), www.whitehouse.gov/sites/default/files/docs/jason_furman_remarks_global_israel_business_conference_12_7_2014_final_2.pdf

Gordon, Robert J, 2012, "Is US Economic Growth Over? Faltering Innovation Confronts the Six Headwinds", *National Bureau of Economic Research Working Paper* 18315, <http://economics.weinberg.northwestern.edu/robert-gordon/Is%20US%20Economic%20Growth%20Over.pdf>

Gordon, Robert J, 2014, "The Demise of US Economic Growth: Restatement, Rebuttal, and Reflections", *National Bureau of Economic Research*, http://economics.weinberg.northwestern.edu/robert-gordon/NBER%20P383F%20Sequel_140126.pdf

Kaminska, Izabella, 2013, "Summers on Bubbles and Secular Stagnation Forever", *Financial Times* (18 November), <http://ftalphaville.ft.com/2013/11/18/1696762/summers-on-bubbles-and-secular-stagnation-forever/>

Krugman, Paul, 2010, "The Third Depression", *New York Times* (27 June), www.nytimes.com/2010/06/28/opinion/28krugman.html?_r=0

Krugman, Paul, 2013a, "A Permanent Slump?" *New York Times* (17 November), www.nytimes.com/2013/11/18/opinion/krugman-a-permanent-slump.html?_r=1

Krugman, Paul, 2013b, "Secular Stagnation, Coalmines, Bubbles, and Larry Summers", *New York Times* (16 November), <http://tinyurl.com/ouolxz9>

Maito, Esteban Ezequiel, 2014, "The Historical Transience of Capital", <http://gesd.free.fr/maito14.pdf>

McKinsey Global Institute, 2015, "Debt and (Not Much) Deleveraging" (McKinsey & Company, February), <https://thenextrecession.files.wordpress.com/2015/02/mckinsey-debt-not-much-deleveraging-040215.pdf>

Roberts, Michael, 2009, *The Great Recession: Profit Cycles, Economic Crisis—A Marxist View* (Lulu Enterprises).

Roberts, Michael, 2013, "From Global Slump to Long Depression", *International Socialism* 140 (autumn), <http://isj.org.uk/from-global-slump-to-long-depression>

Rogoff, Kenneth. 2014, "Malthus, Marx, and Modern Growth", Project syndicate (4 March), www.project-syndicate.org/commentary/kenneth-rogoff-identifies-several-obstacles-to-keeping-living-standards-on-an-upward-trajectory

Shaikh, Anwar, 2010, "The First Great Depression of the 21st century", *Socialist Register 2011: The Crisis This Time*, <http://socialistregister.com/index.php/srv/article/view/14330>

Smith, Noah, 2015, "What We Know About Recessions Might Be Wrong", *Bloomberg View* (11 February), www.bloombergvew.com/articles/2015-02-11/what-we-know-about-recessions-might-be-wrong

Tapia Granados, José, 2013, "Does Investment Call the Tune? Empirical Evidence and Endogenous Theories of the Business Cycle", *Research in Political Economy*, volume 28, http://sitemaker.umich.edu/tapia_granados/files/does_investment_call_the_tune_may_2012_for_thcoming_rpe_.pdf

Tapia Granados, José, 2014, "From the Oil Crisis to the Great Recession: Five Crises of the World Economy", paper presented at the ASSA-AEA 2014 Meeting, Philadelphia.

Wolf, Martin, 2013, "Why the Future Looks Sluggish", *Financial Times* (19 November), <http://tinyurl.com/pq27bda>