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ABSTRACT

This paper discusses the reemergence of Keynesian economics during the past decade. It highlights the substantial differences between new Keynesian economics and the convictions of early Keynesians. In particular, it points out that new Keynesians have adopted many views that were once considered "monetarist" or "classical." It concludes that the term "Keynesian" may have outlived its usefulness.

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The title of this session, "Keynesian Economics Today," says much about what has happened in macroeconomics during the past decade. When I began graduate school at MIT in 1980, it was not at all clear that Keynesian economics would still be around in the 1990s. Keynes looked as if he were leaving macroeconomics and entering the history of thought. The leading intellectual figure of the day was Robert Lucas, and he had this to say about the state of Keynesian economics:

> "One cannot find good, under-forty economists who identify themselves or their work as "Keynesian." Indeed, people even take offense if referred to as "Keynesians." At research seminars, people don't take Keynesian theorizing seriously anymore; the audience starts to whisper and giggle to one another."

Lucas called his article, "The Death of Keynesian Economics."

From our current perspective, it is clear that this obituary was premature. Today, Keynesian theorizing does not inspire whispers and giggles from the audience. There are many economists under the age of forty who do not take offense when their work is called "Keynesian," and I count myself as one of them. If Keynesian economics was dead in 1980, then today it has been reincarnated.

David Romer and I have recently assembled some of the articles that have been central to this reincarnation in a two-volume collection called <u>New Keynesian Economics</u>. The topics covered in this collection--such as imperfect competition, menu costs, coordination failure, and efficiency wages--are those that have dominated discussions among Keynesians over the

past decade. It is too early to say that there is a consensus about how all these topics fit together. Yet one can say that the new classical challenge has been met: Keynesian economics has been reincarnated into a body with firm microeconomic muscle.

I am careful to call this reemergence of Keynesian economics a "reincarnation" rather than a "resurrection." My dictionary defines "reincarnation" as "the rebirth into another body," and that describes well Keynesian economics today. The Keynesian economics of the 1990s shares the spirit of the Keynesian economics of earlier decades. Like their predecessors, new Keynesians question the relevance of the Walrasian paradigm in explaining economy-wide booms and busts. Old and new Keynesians share a skepticism in the invisible hand's ability to maintain full employment. They both see the business cycle as a type of economy-wide market failure.

Beyond these broad principles, however, old and new Keynesians differ substantially. In many ways, the Keynesian economics of the 1990s does not look like the Keynesian economics of the 1930s, or even that of the 1960s. To some old Keynesians, new Keynesian economics may be hard to recognize as Keynesian at all. Indeed, new Keynesian economics may appear more similar to the classical economics of David Hume, or even to the monetarist economics of Milton Friedman.

My goal today is to highlight some of the differences between old and new Keynesian economics. In particular, I would like to discuss six dubious Keynesian propositions. These are propositions that various economists in the past have viewed as basic tenets of Keynesian economics and that, I believe, economists today should discard.

My list of dubious Keynesian propositions is highly personal. I surely would not claim that all new Keynesians view all of these propositions as dubious. Yet my list is not entirely idiosyncratic. I present these dubious Keynesian propositions in part to show the profound impact that monetarism and new classicism has had on the thinking of my generation of Keynesians.

Dubious Keynesian Proposition #1: Learning how the economy works is best achieved by a careful reading of Keynes's General Theory.

Since Keynesian economics is derived, by definition, from the work of John Maynard Keynes, one might suppose that reading Keynes is an important part of Keynesian theorizing. In fact, quite the opposite is the case. Few young economists--Keynesian or otherwise--concern themselves with question of what "Keynes really meant." New Keynesians view their work as following in the broad oral tradition that evolved from Keynes, but their goal is to explain 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 rigor with which we develop economic theories and the data and statistical techniques with which we test our theories were unknown half a century ago. We are in a much better position than Keynes was to figure out how the economy works.

Dubious Keynesian Proposition #2: The lessons of classical economics are not helpful in understanding how the world works.

Perhaps for dramatic effect, or perhaps because he was writing in the midst of the Great Depression, Keynes minimized the lessons of classical economics. He called classical economics a "special case" of his general theory, and he wrote that

> "the characteristics of the special case assumed by classical theory happen not to be those of the economic society in which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the facts of experience."

If The General Theory were to have had a subtitle, it might have been "The Death of Classical Economics."

Today, few macroeconomists take such a dim view of classical economics. Most accept the natural-rate hypothesis, which interpreted broadly states that classical economics is right in the long run. Moreover, economists today are more interested in the long-run equilibrium. The long run is not so far away that one can cavalierly claim, as Keynes did, that "in the long run we're all dead."

The widespread acceptance of classical economics is evidenced by the reemergence of economic growth as an active area of research. The starting point of all modern growth theory is the Solow growth model. The Solow growth model is eminently classical: it begins by simply assuming that the economy reaches full employment. Although there is continuing debate about

whether the Solow model provides an adequate description of economic growth, the model is rarely criticized as being too classical.

Dubious Keynesian Proposition #3: Capitalist economies are threatened by the possibility of excessive saving, which could lead to secular stagnation; deficit spending is, therefore, good for the economy.

About ten years ago Martin Feldstein wrote an article called, "The Retreat from Keynesian Economics," in which he wrote that

> "the most direct effect of Keynesian thinking has been to retard the process of capital formation. Keynes's own writing displayed not only a lack of interest in the potential benefits of capital accumulation but also an outright fear of excessive saving."

More recently, Feldstein has suggested that Keynes was the "academic scribbler" who unwittingly inspired Ronald Reagan's decade of budget deficits. (Feldstein 1988)

Once again, we see a stark contrast between old and new Keynesians. Feldstein is correct that some early Keynesians feared that the economy might suffer from "secular stagnation" if the propensity to save were too great. By contrast, few economists today believe that excessive saving threatens the economy. Instead, almost all economists now believe that additional saving will, in the long run, lead to additional investment rather than inadequate aggregate demand. Indeed, rather than being concerned with excessive saving, most American economists fear that the U.S. saving rate is inadequate to maintain America's high standard of

living.

Dubious Keynesian Proposition #4: Fiscal policy is a powerful tool for economic stabilization, and monetary policy is not very important.

The first course I took in macroeconomics used Samuelson's famous textbook. Like many students in my generation, my class was introduced to macroeconomic modelling with the Keynesian cross. Our first lesson was that fiscal policy is a powerful tool that policymakers could (and indeed should) use to control national income. After we learned about the magic of the multiplier, we did study several ancillary topics, such as the role of monetary policy, but we always kept the Keynesian cross as the benchmark model of the economy.

From a modern perspective, it seems most peculiar to begin the study of macroeconomics with the Keynesian Cross. The most striking features of this model are what it lacks: any connection to microeconomics, any self-correcting forces returning the economy to the natural rate, and any role for the central bank. Moreover, as an empirical matter, the message of the model is more wrong than right. The numerical examples regularly given to students suggest that the multiplier is indeed quite magical. But, in the world, fiscal policy is not so potent. For example, the quintessentially Keynesian DRI model estimates the government-purchases multiplier (holding the money supply constant) to be only about 0.6. (Eckstein 1983, p. 169)

For the purpose of analyzing economic policy, a student would be better equipped with the quantity theory of money (together with the expectations-augmented Phillips curve) than the Keynesian Cross. In the United States today, fiscal policymakers have completely abdicated

responsibility for economic stabilization. Their inability to cope with persistently large government deficits has left them unable even to imagine trying to reach consensus on countercyclical fiscal policy in a timely fashion. All attempts at stabilization are left to monetary policy. When a recession ensues, as it did recently in the United States, fiscal policymakers merely begin discussions about what the Federal Reserve did wrong.

Dubious Keynesian Proposition #5: Policymakers should learn to live with inflation, because it is the cost of low unemployment.

In his Presidential Address to the American Economic Association in 1971, James Tobin argued that the "zero-inflation unemployment rate" is not optimal. What is noteworthy about this fact is not that Tobin reached this conclusion but that he even chose to ask the question. The very phrase "zero-inflation unemployment rate" presumes the existence of a long-run tradeoff between inflation and unemployment. Most economists today doubt that such a tradeoff exists. On this issue, Milton Friedman (1968) has won the hearts and minds of my generation: in most new Keynesian models, the long-run Phillips curve is vertical.

Perhaps surprisingly, the intellectual victory of the natural-rate hypothesis has not lead to consensus among macroeconomists on the relationship between inflation and unemployment. Instead, the debate has shifted focus to the short-run relationship. New Keynesians are the keepers of the faith that policymakers face a short-run tradeoff between inflation and unemployment. New classicals, who have devoted their energy over the past decade to real-business-cycle theory, deny the existence of

any tradeoff over any time horizon.

Here we can see how misleading the labels have become. Old classical economists, such as David Hume, asserted that money was neutral in the long run but not in the short run. This is exactly the position held by new Keynesians. By contrast, new classical economists claim that money is neutral even in the short run. In advocating this position, they take the classical dichotomy more seriously than did the classical economists themselves.

Dubious Keynesian Proposition #6: Policymakers should be free to exercise their discretion in responding to changing economic conditions and avoid adherence to a rigid policy rule.

One striking feature of the economic history of the past fifty years has been high and persistent rates of inflation. Between 1940 and 1990, U.S. inflation averaged 4.6 percent per year. By contrast, between 1870 and 1940, the inflation rate averaged only 0.4 percent per year. In other words, since Keynes wrote The General Theory, the U.S. economy has become far more prone to inflation.

This is, I suspect, not merely a coincidence. At its broadest level, The General Theory is a call for monetary and fiscal policymakers to control the economy through the management of aggregate demand. In the aftermath of the Great Depression, policymakers were ready to hear this message. The U.S. government accepted the challenge with the Employment Act of 1946, which stated that "it is the continuing policy and responsibility of the Federal government to...promote full employment and production." In essence, Keynes ushered in an era of discretionary demand

policy.

It was not until the 1980s, however, that economists developed a good understanding of why discretionary policy is intrinsically inflationary. The literature on time inconsistency contains an important warning: At any point in time, policymakers with discretion are tempted to inflate in order to reduce unemployment. Economic actors, however, come to understand this temptation and adjust their expectations of inflation accordingly. Higher expected inflation in turn causes the short-run tradeoff between inflation and unemployment to deteriorate. In the end, discretionary policy yields higher inflation without lower unemployment.

The literature on time inconsistency has provided a case for a commitment to a monetary-policy rule that many economists find persuasive. The most widely discussed such rule is a target for nominal GNP, although other rules, such a target for the price level or for the nominal wage, would have similar long-run properties. Without a commitment to such a policy rule, the modern central bank may be unable to achieve the often stated goal of price stability.

Does Macroeconomics Make Progress?

In some ways, the history of macroeconomic thought seems like a pendulum swinging between two views of the economy. On the right is the classical view of a well-functioning economy; on the left is the Keynesian view of an economy fraught with market failure. The Great Depression of the 1930s swung the pendulum decisively from the right to the left, and Keynes could plausibility call classical economics "misleading and disastrous." The new classical economics of the 1970s swung the pendulum

back to the right, and Robert Lucas could plausibility proclaim the "death of Keynesian economics." The new Keynesian economics of the 1980s swung the pendulum back toward the left (at least somewhat), and today one can plausibly say that Keynesian economics has been reincarnated.

One might be tempted to conclude from these developments that macroeconomics does not make progress, that it is destined to oscillate between two irreconcilable extremes. Yet one can also take a more sanguine view. The new classical revolution of the 1970s left an indelible mark on the way macroeconomists of all stripes think about the economy, just as the Keynesian revolution of the 1930s did before it. 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. With new Keynesians looking so much like old classicals, perhaps we should conclude that the term "Keynesian" has out-lived its usefulness. Perhaps we need a new label to describe the school of macroeconomics that accepts the existence of involuntary unemployment, monetary non-neutrality, and sticky wages and prices. Until a new label is found, however, we can safely say that Keynesian economics is alive and well.

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