Introduction

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ABOUT MONEY, METHOD AND CONTEMPORARY POST-KEYNESIAN ECONOMICS

The chapters in this volume, and its companion volume, *The General Theory and Keynes for the 21st Century*, originated in a celebration marking the happy coincidence that 2016 saw the 80th birthdays both of the publication of Keynes's *General Theory of Employment, Interest and Money* and of Victoria Chick, who has contributed so much to the development of Post-Keynesian theory and method. Her monograph *Macroeconomics after Keynes: A Reconsideration of the General Theory* has been one of the stepping stones for two generations of macroeconomists. As with Keynes, from the very beginning of her career monetary, banking and financial theory have been of special interest: how to analyse the development of money and finance, and the intertwined relationship between financial and real activities.

The chapters in these volumes serve as a reminder to academic and professional economists of the narrowness, let alone the limited relevance, of the conventional account of Keynes. They are indicative of a more substantial and richer approach to economics, just as mainstream economics is being forced to confront its grave limitations in the wake of the global financial crisis and subsequent stagnation. Those from the mainstream who are approaching these limitations in a constructive manner are therefore found assessing the nature of money and deposit creation, the role of uncertainty and ideas around multiple equilibria – constant themes of Vicky's research.

The publication in 1936 of Keynes's *The General Theory of Employment, Interest and Money*, the book which lies at the core of Vicky's work, had immediately set a new agenda for understanding macroeconomics. In the second half of the 20th century it became for a while the most quoted book in macroeconomics. For many economists, *The General Theory* continues to be the most important text.¹ But the undercurrent of

¹ See, for example, <http://www.paecon.net/PAERReview/issue36/greatest20thcenturyeconomists.htm>.

mainstream macroeconomics changed during the last three decades of the 20th century. Keynes's economics, or rather Keynesian economics, was increasingly challenged by a neoclassical counter-revolution. The decline of prestige of Keynesian macroeconomics and politics was a consequence both of the stagflation of the 1970s, which could not be explained within the conventional Keynesian textbook models or econometric macro models, and of more (neo)liberal politicians being in power.

This development had been underway for quite a long time. As far back as in 1968 Milton Friedman was successful in initiating this counter-revolution by his Presidential address to the American Economic Association. There he presented a simple but seemingly correct prophecy that another analytical approach in macroeconomics was needed to explain rising unemployment and inflation. The new field of macroeconomics was in some ways a retreat to pre-Keynesian economics, with monetary and real-sector economics being separated, the longer-run Phillips curve made vertical, and the money supply assumed to be controlled by the central bank. This general equilibrium framework was shortly after elaborated by the New-Classical macroeconomists, guided by Lucas and Sargent (1978), among others. They claimed that the general equilibrium model needed an explicit microeconomic foundation to secure a stable structure of households' and firms' behaviour and market equilibrium. They introduced an analytical framework building on representative agents, who were assumed to conform to the principles of individual rationality and the hypothesis of rational expectations (that is, correct information about the economic model).

This counter-revolution in macroeconomic theory and method began to dominate the macroeconomic arena during the 1980s, and textbooks were rewritten. Now the neoclassical microeconomic foundation together with 'rational expectations' became the standard, and neoclassical growth theory was given priority over business cycle theory; both kept within a methodological framework of general equilibrium models. In addition money and finance were relegated from the analysis of real sector activities. Direct references to Keynes and Keynesianism became rare within this real business cycle and neoclassical growth theory paradigm, except for remarks, with an antagonistic tone, critical of the previously-conventional Keynesian approach.

However, weak growth rates and rising unemployment in the US and Europe during the early 1990s made some macroeconomists uneasy with the rigid real sector equilibrium model. Instantaneous and persistent equilibrium with no involuntary unemployment was difficult to defend in the face of this reality. Hence, within the new framework of general equilibrium a group of macroeconomists started to argue that, due to a

number of rigidities in the real world, mainly a lack of price and wage flexibility but also of an institutional kind (referring for example to the welfare state), markets would not and could not adjust instantaneously to external real shocks. This elaborated general equilibrium approach could better explain short-term business cycles and deviations from the level of ‘natural’ or ‘voluntary’ unemployment. For reasons which are difficult to explain, this group of macroeconomists called themselves New-Keynesian economists (see Mankiw and Romer 1991). One possible explanation for this contradictory label was their conclusion, expressed in opposition to Robert Lucas’s ‘policy ineffectiveness’ claim, that, in the (very) short run, demand management policies could have an effect on the real business cycle due to these real-life rigidities. Of course, New Keynesians also considered a removal or reduction of market inflexibility as the first-best policy. But, faced with reality (a lack of information, transaction costs and institutional arrangements), short-term rigidities could be given a rational explanation. Hence, Mankiw (2016, p. 11, emphasis in the original) writes in his textbook *Macroeconomics* that ‘[f]or answering most questions, economists use market-clearing models. Yet, the assumption of *continuous* market clearing is not entirely realistic’.²

While the IS–LM Keynesian economists had been dominant during the 1950s and 1960s, from mid-1970 the dominance had therefore shifted to the New-Classical/New-Keynesian general equilibrium economists. But, parallel to these mainstream macroeconomic paradigms, there has been an undercurrent of other macroeconomic schools, which reflected unease with these rather mechanical market-clearing models that were partly detached from reality. Among these schools, Post Keynesians have been one of the dissenting groups of macroeconomists ever since 1936 (see King 2002). Post-Keynesian economists unite in emphasising the need for theory and methods which give priority to understanding real-world phenomena. This agenda is challenged by the fact that reality is an ever-moving target. Therefore *The General Theory* cannot be considered as a manual for all seasons, but rather an elaborate framework for understanding parts of a dynamic system. The emphasis was on the most pressing social and economic problems of the 1930s. But then parts of *The General Theory* are still as relevant for today as they were back in the 1930s. Indeed many of the macroeconomic challenges we confront today originate in the same defects of domestic and international economic architecture that Keynes sought

² He continues, ‘Market-clearing models might not describe the economy at every instant, but they do describe the equilibrium towards which the economy gravitates’ (Mankiw 2016, pp. 11–12). The quoted passages are unchanged from the 1st edition (1992) to the 9th edition (2016).

to resolve, and they exemplify the extent of the distortions of this theory that are also not yet resolved. Keynes's emphasis on macroeconomics as an analytical strategy for building knowledge of an ever-moving target was combined with his emphasis on the ontological significance of uncertainty related to the formation of expectations. Keynes's work in economics and philosophy can be read as one painstaking attempt to develop a method of how to analyse reality.

TWO MAJOR THEMES: (1) MONEY, CREDIT AND FINANCE AND (2) MACROECONOMIC METHODS

This volume focuses on Post-Keynesian economics, while the companion volume, *The General Theory and Keynes for the 21st Century*, focuses particularly on Keynes, and especially on *The General Theory* (GT). The contributions to this volume fall broadly into the two themes of Chick's work: money and method, analysed either from a Post-Keynesian perspective or in a constructive dialogue with Post-Keynesian economics.

The first theme could be labelled 'Money and the Real World', with reference to Davidson (1972). If anything separates Post-Keynesian economics from mainstream macroeconomics it is the latter's claim that money and finance are neutral. As soon as uncertainty is introduced into the epistemological structures of macroeconomic analysis, it becomes obvious that money and finance cannot be separated from real activities. Money and uncertainty are in this respect like Siamese twins: they cannot analytically be dichotomised. Furthermore, the topic of money directs attention to private banks as the main issuers of money in a modern society, while the topic of finance directs attention to shadow banking, financialisation and so on, all as part of a full-scale monetary theory relevant for understanding the real world.

The second theme is Macroeconomic Method. It has at least indirectly been a focus point ever since the publication of the GT. But the understanding of the importance of what the choice of method implied had to wait – we think – for the seminal work of Chick (1983). There the methodological meaning and analytical use of the concept of equilibrium in neoclassical theory (market clearing) and in the GT (a 'standstill' caused by counter-balancing macroeconomic forces) was dissected. It is hardly an exaggeration when King (2002) calls one of the chapters in his book on the *History of Post Keynesian Economics since 1936* 'the incubus of Equilibrium'. This analytical concept of *equilibrium* has caused a lot of methodological disagreement, even among Post-Keynesian scholars.

However, the methodological perspective within Post-Keynesian economics was broadened in the 1980s, when scholars began to combine some

of Keynes's early and more philosophically-inspired writings with his economic treatises. His fellowship dissertation from 1909, which was not published until 1921 under the title of *A Treatise on Probability*, played an instrumental role in this process. Here, Keynes discussed how to develop a rational theory of probability when information is lacking (see among others Carabelli 1988; O'Donnell 1989).

THEME 1: *MONEY, FINANCE AND CONTEMPORARY POST-KEYNESIAN ECONOMICS*

The 21st century had hardly begun before the US financial crisis spread globally, emphasising how important money, banking and finance are for macroeconomics, before and since. Victoria Chick's interest in promoting understanding of the history of money, banking and monetary policy is reflected in the opening chapter of this volume.³ Here Charles Goodhart goes all the way back to the mid-19th century, where the debate between the banking school and currency school was formally closed in England by adopting the Bank Charter Act of 1844. It was on the surface a victory for the currency school, with strict control of the money supply, which is interpreted by modern mainstream economists as putting price stability at the top of the policy agenda. In this chapter it is argued with reference to Ricardo that the Bank Charter Act was initially not introduced as a means to improve monetary policy management and price stability. A similar story can be told after the breakdown of the Bretton Woods system and the (associated) stagflation of the 1970s, where monetary authorities, both central banks and finance ministries, were left without a regulatory regime in their own country. The initial response, a pragmatic form of monetarism in the guise of monetary targets, proved unsatisfactory during the 1980s. It was succeeded in the 1990s by the adoption of inflation targeting. However, the historical irony is that neither of the monetary regime changes on which this chapter focuses was *initially* intended as being primarily a matter of monetary policy adjustment. Instead, Ricardo's main aim for a monetary reform was to transfer seignorage receipts from the private sector Bank of England to the public purse. Similarly, the more recent change, the adoption of inflation targeting as the operational rule for central banks, had a wider scope. This was demonstrated first in New Zealand in 1984–90. The reform was an integrated part of a wider search for proper operational rules of conduct for *all* public-sector corporations,

³ See also Chick (2018).

not only the Reserve Bank of New Zealand, in an attempt to improve the working of public institutions in general and with less direct interference by politicians.

Geoff Tily takes issue in his chapter (Chapter 2) with the nearly global stagnation of the early 21st century, which, in his reading of *The General Theory*, is not natural or inevitable, but the result of incorrect monetary policy towards the rate of interest and banking practice. His analytical point of departure is the conventional diagrammatic relationship between interest and investment in real capital. An alternative diagrammatic technique is proposed ($Mr - rI$) and used to demonstrate how high investment and therefore employment might be sustainable under cheap money but unsustainable under dear money. The high level of economic activity in the three decades just after the Second World War supports the argument of benefiting from a monetary regime securing cheap money. Conversely, the subsequent deterioration of macroeconomic performance over the last three decades – with the deep crisis from 2007 to 2008, followed by the Great Recession – shows the costs of a monetary policy being institutionally detached from responsibility for real activity. The chapter ends with a plea to reconsider Keynes's call for a *monetary theory of production* and his associated practical proposals for the reform of international and domestic monetary architecture as potentially still relevant today.

Roy Rotheim follows the same set of monetary arguments (Chapter 3). For the last three decades central banks have been committed to undertaking monetary measures without much success. The policy has been geared toward dampening inflation expectations and to securing consumer price inflation rates such as to reach the targets set by their respective monetary policy committees or in some cases by the government. This monetary regime and strategy is predicated on the assumption of competitive firms lowering their prices as a response to higher interest rates and a weakening of demand for goods and services. It also relies on the belief that inflation expectations, and inflation itself, can be dampened with no lasting effect on the overall level of effective demand and employment. The author claims that firms having some control of the market price of their output will respond differently in cases of monetary restraint. They will typically raise their mark-ups over unit costs to provide necessary finance rather than seek funds externally, when interest rates are higher. To the extent that such effects are pervasive, it may be the case that monetary restraint will result in more inflation. How much prices may rise in response to monetary contraction will depend on the ability of firms to control their mark-ups and on the extent to which the demand for finance will increase when monetary restraint causes effective demand to fall. So, the potential costs of monetary restraint take on a different hue when put into a

Post-Keynesian framework where debt is fixed in money terms and where the cost of servicing that debt has real consequences as well as potential consequences for pricing policy.

In Chapter 4 Penelope Hawkins takes a specific look at the role of banking at different stages of development. This is an evolutionary approach to banking with explicit inspiration from the theoretical framework developed by Victoria Chick. This approach gives a better understanding of the institutional behaviour of banks in response to central banks' activities. Hereby the transmission of monetary policy and bank regulation were given a frame of reference which emphasised the historical and institutional context. The chapter expands this relational theory to include the non-bank public of smaller firms and households, who are so dependent in a modern society on the circulation of private bank money and the availability of bank credit. Without any external access to liquidity these actors are at the mercy of how private banks react to central bank monetary regulation. This relationship has developed through time. To get the full understanding of this monetary transmission mechanism it is necessary to develop an explicit evolutionary theory. Banking has evolved in a number of stages. Application of these stages of banking to consumers in the right historical perspective provides insight into how credit could be obtained by households and small firms within a particular context. This chapter focuses primarily on banking in South Africa. It is demonstrated how the evolutionary approach provides a better understanding of why, among others, African Bank, a South African bank specialising in household micro-lending, failed due to inappropriate bank regulation based on inadequate monetary theory. In the early stages of banking development, household credit was nearly unobtainable. If anything, micro-credit had to be 'invented'. At some later stage households were provided with access to bank loans, but without the necessary banking and regulatory insight and experience, these loans often turned out to be unsustainable. To the extent that this development applied globally, the present financial crises became widespread.

Jayati Ghosh tells a similar story, but related to East and Southeast Asian economies (Chapter 5). In these regions the financial system had, until thirty to forty years ago, its own specific development. The state, together with the really big firms, was directly involved in the processes of extending and controlling credit. It was a highly-regulated financial system domestically, combined with external capital control to stabilise the financial sector and to limit unpredictable volatility. This system seemed to have served the Asian market economies quite well until the 1980s. But then the financial 'philosophy' changed, led by the Washington Consensus. Financial liberalisations were enforced in many countries of the region

during the final decade of the 20th century. Their financial structures started to be transformed in line with credit market and monetary institutions in the Anglo-Saxon world, within a much less tight regulatory framework. This change made the financial system of these countries more fragile and allowed for debt-driven boom and bust cycles in housing and other asset markets. Hereby many sources of financial vulnerability, both external and internal in origin, have been imposed and reduced the political potential for structural changes, even in countries where the development project was far from complete.

Sunanda Sen takes a more specific look in her chapter (Chapter 6) at shadow banks, which operate beyond the regulation of the monetary authorities in different parts of the world, with especial attention to emerging economies like India. The starting point is an explanation of shadow banks in more advanced economies. Their activities can largely be explained by the increased deregulation of financial markets, which has created space for more risky financial investments. The major thrust of the chapter is to deal with the use and abuse of shadow banking in India, both by those providing credit to the unbanked and financially excluded (unorganised) sectors of the economy, and by those which are closely connected with the organised sector. Thus the definition of shadow banking covers a broader range of institutions in India than is usually seen in the literature. Specific issues in the functioning of these banks and other lenders in India are discussed. They do overcome some of the problems related to credit rationing of hitherto unbanked actors in the more remote parts of the economy, but often on onerous terms. Furthermore, shadow banking creates loopholes for money laundering by the non-bank financial companies in the organised sector. So shadow banking is a mixed blessing in a grey area which is difficult for the regulatory authorities to control as long as the liberal monetary regime is maintained.

In Chapter 7 Rogério Studart asks the question: how can financial sector activities contribute to the necessary transformation of infrastructures to support the aspiration of creating Global Sustainable Development? Most analysts agree that boosting such investment globally will require a significant rethinking of the role of international and national public financial institutions. International financial flows, especially to the developing countries, could be more specifically linked to direct investment and, further, long-term infrastructures in sustainable energy, clean water supply, education and basic health care could be given priority. Such a change cannot be expected to happen within a deregulated market system of international finance dominated by private investment banks. This conflict between the long-term perspectives of real investment and the short-term horizon of financial speculation was already discussed in

Chapter 12 of *The General Theory*. Studart's chapter brings this discussion up to the present day by drawing on Victoria Chick's insights on the relation between institutional evolutionary development, real investment and modern finance theory (see also Chapter 8 in this volume). The chapter concludes by explaining why this framework could be a useful back-drop for the understanding of how to promote sustainable infrastructure investment globally by international financial reforms (see also Chapter 12 in this volume).

Carlos Rodríguez-Fuentes devotes his chapter (Chapter 8) to reviewing central themes within Victoria Chick's contributions to monetary-macroeconomic theory. Two principles are especially emphasised as a continuous undercurrent in Chick's monetary thought: (1) the notion that the monetary change is only 'one half of the story' of how the macroeconomic system really works, and (2) the development, structure and evolution of the banking system matter for the way that monetary policy works and the banking system influences economic development. Within macroeconomics, money and finance cannot in any comprehensive way be analysed or discussed independently of the many intertwining relationships with real sector activity. From a Post-Keynesian perspective, one of the main characteristics of macroeconomic analysis is to acknowledge that the theory is dealing with what Keynes at an early stage called 'A Monetary Theory of Production'. Having said that, it is legitimate to look in more detail at specific sectors as parts of the economy as a whole. Chick has devoted much of her research to the evolution of private banks. The financial technology has developed so much since the interwar period, when already Keynes warned that 'the position is serious when enterprise becomes the bubble on a whirlpool of speculation' (Keynes 1936, p. 159). The chapter ends by suggesting that these two principles, which are so crucial for the understanding of how a monetary economy works, should become a new standard for teaching in macroeconomics.

THEME 2: *MACROECONOMIC METHODOLOGY AND POST-KEYNESIAN ECONOMICS*

Bert Tieben asks in his chapter on 'Equilibrium and uncertainty' (Chapter 9): why use a static concept like equilibrium if the aim of theory is to say something useful about the real world which is inherently dynamic? If anything, Post-Keynesian economists have been struggling with this very relevant question of how to find a method to bridge the gap between static theory and dynamic reality. The author discusses, among others, Victoria Chick's solution of a 'shifting equilibrium model' to this apparent

paradox. In addition, it is argued that rival schools of thought such as Austrian economics face a comparable dilemma, which leads them to reject the equilibrium concept in favour of alternatives such as ‘market process’, ‘path dependency’ or ‘evolution’. However, from a methodological point of view such alternative analytical practices play an epistemological role which is comparable to that of the equilibrium concept. By using Shackle’s notion of kaleidic equilibrium, this similarity is explained and Shackle’s suggestion recognised. Hence, the chapter concludes by giving support to Keynes’s (and Shackle’s) macroeconomic method, where the construct of an equilibrium, if it is carefully defined, is helpful to better understand the operation of an ever-moving world ruled by uncertainty.

Mogens Ove Madsen demonstrates, in Chapter 10, how John Hicks was struggling with the methodological problem of making a proper analysis of a dynamic system using an equilibrium concept, as discussed by Bert Tieben in this volume. Throughout his research Hicks was aware that ‘time is a one-way street’. Historical time is always moving forward. So Hicks was concerned that progress in economic thinking had to loosen economic models from a static framework in order to be able to incorporate historical time. The author’s claim is that, through his continuous self-criticism, Hicks has been able to contribute to the fundamental question of bringing macroeconomic theory closer to economic reality. Although coming from the London School of Economics, where Lionel Robbins dominated, Hicks did recognise in his review of *The General Theory* (1936) one of the real novelties: Keynes’s emphasis on uncertain expectations as being important for macroeconomic development. One can read Hicks’s works as a lifelong search for a method where historical time as an irreversible factor is given its proper analytical role. Hicks’s increasing concern with the role of time in macroeconomics is argued to be a central key to following his lifelong project of understanding the economics of Keynes and of the real world. The author comes close to concluding that Hicks was a (Post-) Keynesian economist ever since 1936 by sentiment, but his intellectual and analytical framework suffered from being established under the strong influence of the Walrasian tradition, at LSE, of thinking in terms of stationary equilibrium.

In Chapter 11 Angel Asensio presents a ‘static model of a dynamic process’ an elaboration of Hicks’s IS–LM model, employing the methodology of shifting equilibrium with endogenous and subjective expectation-formation. This is an important change in the Keynesian analytical tradition, because here different views on an uncertain future can be integrated and make an impact on the outcome of the model. Furthermore, the resulting IS_K – LM_K model does allow for an endogenous determination of wages and prices. This is an important break away from the conventional IS–LM model,

which served as the back-drop of a full-scale general equilibrium where price and wage rigidities are pre-designed to secure the desired outcome (see for instance Mankiw's 2016 textbook). In contrast, the modified IS_K - LM_K model opens up scope for a broad variety of outcomes, which, among others, includes the potentially destabilising feedback effect on effective demand of wage adjustment to unemployment, explicitly mentioned by Keynes in Chapter 19 of *The General Theory*. In spite of the destabilising effect associated with competitive forces, an equilibrium can arise at any point in time, due to institutional forces, 'money illusion', market power and public regulation and so on, existing in the real world and, therefore, introduced into the analytical model. Hereby, major shortcomings of the original IS - LM framework are removed, and a static representation of an intrinsically dynamic economy is made possible.

Victoria Chick and Alan Freeman take departure in their chapter 'The economics of enough?' (Chapter 12) from Keynes's *General Theory* Chapter 17, in which he discusses the tendency of the marginal efficiency of capital to fall as capital accumulates. This view of capitalism is not a novelty. A number of the classical economists (Ricardo and Marx for example) asked the same question of the possibility of the economy ending up in a stationary state because of a lack of incentive to accumulate real capital. This chapter explores Keynes's evaluation of this possible long-term prospect for capitalism. Few studies have gone into the reasons for Keynes's claim that capitalism exhibits a tendency towards a stationary state or of the social implications of such a development. Possible consequences of this long-term decline are explored. The authors claim that advanced countries are heading towards such a state, which has hitherto partly been disguised, as well as enforced, by financialisation. They conclude that to prevent this from happening calls for a practical, as well as an ethical, response, which could take the form of a concerted move towards policies and international cooperation based on sustainability and the full development of human creativity. Such a development, however, as Keynes envisaged, precludes investment being decided on short-term financial returns and instead accepts accumulation being undertaken for the common good decided in the public sphere.

In Chapter 13 Robert McMaster follows up on the perspective of advanced economies heading towards a stationary state, but this time due to a levelling-off of demand for ordinary consumer goods, owing to their abundance. In *The General Theory* Keynes briefly contemplated this possibility of a society dealing with the problems of zero economic growth by looking into the Economics of our Grandchildren. His tone was quite optimistic. A stationary state was not to be feared as it offered the prospect of a better and more relaxed society. As argued in the

previous chapter, there are a number of factors pointing to lower growth in GDP and shorter working hours in the 21st century. This situation of saturation of produced goods may offer an opportunity for re-thinking a stationary state of conventional GDP, not as stagnation, but rather as providing a basis for a society with changed preferences. Shorter working hours do not necessarily mean less social activity: instead of producing goods one could provide services in the form of care. Today, care is in short supply due to the way in which it is organised. Private insurance for health and care is expensive, and supply of public welfare is restricted due to austerity policies. So ordinary people are looking for more care in the form of health care, nursing homes, kindergartens and better public transport, for example, but they cannot afford it. This dilemma is overlooked and underrated in much of conventional economic thinking. But even within the Post-Keynesian literature this aspect of lack of welfare is underdeveloped. There is a general critique of austerity policies and the fetishism of a balanced public-sector budget, but when it comes to the more specific analyses of how to secure a good and caring society, the Post-Keynesian economists are surprisingly silent. Here, scholars rather have to go to institutional or feminist economics or even to other disciplines like sociology. Post-Keynesian economists have been reluctant to go deeper into the analyses of how to organise the public sector to comply with the increasing demand for care by ordinary people. In short, the chapter encourages Post-Keynesian economists to develop principles for the welfare state (mark II) for the 21st century.

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