Davidson on Keynes and Others – A Rejoinder

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It is, no doubt, impressive to see that Professor Davidson is able to gather from a mere two-page text what the head of its author is »filled up with« (he uses this expression twice). Having read many books and articles written by Paul Davidson I, for my part, would not dare to design such an assessment. Given the page restriction, I did not intend to embark on an in-depth discussion of his latest book on Keynes. Instead, I thought of a more or less informed reader of my review to whom I offered some remarks on the contents of the book.

Some of these readers, I guessed, got to know Davidson as a member of the famous triumvirate embracing Kregel and Minsky which set up the Post Keynesian branch of macroeconomics in the 1970s. Thus I surmised that a reader might ask why hints to the work of those two economists are absent in Davidson's book. I hasten to add that this is a minor point which better should not have been mentioned at all. But now, it is somewhat startling to read that Davidson does not see a necessity of quoting Kregel's work because he was his dissertation supervisor – obviously the disciple can never »add additional credence«, and thus cannot surpass the Master. On the other hand, I totally agree with Davidson's view of Minsky who, despite his merits with respect to the issues of uncertainty and investment theory, was reluctant to recognize that Keynes aimed at an *equilibrium* theory of unemployment.

The negligence of New-Keynesian Macroeconomics in Davidson's book is an omission which was mentioned only because the term was listed in the index. For my part, I would have appreciated an attack on the Woodford (less the Mankiw) branch of modern macroeconomics which, under the heading of *Keynesian* theory, offers a high-browed story of intertemporal consumption and pricing, built on an ad-hoc choice of microfoundation in some fields, as scientific progress. With regard to the issue of learning in macroeconomics, I think Davidson's critique is unjustified: surely »the future cannot be learned in advance«, but the learning approach addresses the important question how agents behave in a world in which there is model and parameter uncertainty. There is no necessary conflict with the non-ergodic axiom, therefore this modern debate should not be assessed as »useless«.

Finally: two points on wage flexibility (it is astonishing that all debates on Keynesianism end up with this topic). Although my review consisted of two pages only, Professor Davidson seems to have overlooked that I praised his book precisely because of its contents with regard to the wage question: »One of the most valuable messages of the book is that Keynes's employment theory does not depend on rigid wages« (Spahn 2008: 208).

My German colleagues will be surprised to learn from Davidson's response that I make a plea for wage reduction in order to reduce unemployment. In general, I have nothing to add to Keynes's Chapter 19 and subscribe to the writings of Hahn and Solow on that matter.

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There is nevertheless a more formal problem with Keynes's argument in Chapter 17. This point was raised by Abba Lerner (1952). Unfortunately, I could only give a hint to his critique in my book review. Lerner accepts Keynes's proposition that the elasticity of substitution of money is nearly equal to zero, because:

> »as the exchange value of money rises there is no tendency to substitute some other factor for it […]. This follows from the peculiarity of money that its utility is solely derived from its exchange-value, so that the two rise and fall *pari passu*, with the result that as the exchange value of money rises there is no motive or tendency, as in the case of rent-factors, to substitute some other factor for it« (Keynes 1936: 231).

However, this line of reasoning undermines Keynes's twin proposition that also the elasticity of production of money is zero.

> »If the total stock in units of money is unchanged but prices fall […] the total stock of liquidity by the same token increases. It is not quite true that the desire for more liquidity is like a ›desire for the moon‹ […]. Unlike the desire for the moon, which has no effects on the satellite, the desire for more liquidity, by raising the value of money, increases its supply. […] The elasticity of supply of liquidity is not zero but unity« (Lerner 1952: 184–185).[1]

Keynes (1936: 232) likewise concedes that the marginal efficiency of holding money might fall because »as money-values fall, the stock of money will bear a higher proportion to the total wealth of the community«. As a consequence, »it is not possible to dispute on purely theoretical grounds that this reaction might be capable of allowing an adequate decline in the money-rate of interest«.

In order to defend the stickiness of the rate of interest, Keynes resorts to more empirical arguments that (1) the low carrying costs of holding money makes the demand for liquidity very elastic (this is the liquidity-trap story); that (2) falling wages and prices might prompt the expectation of a further fall (this is the dynamic story also contained in Chapter 19); and that (3)

> »wages tend to be sticky in terms of money, the money-wage being more stable than the real wage, [which] tends to limit the readiness of the wage-unit to fall in terms of money« (ibid.).

Thus we finally arrive at the heart of the ›controversy‹: some degree of nominal wage stickiness is necessary to confirm the validity of Keynes's two propositions regarding the essential

1 This can be read as an increase of the real money supply, a term that Davidson dislikes: »Keynes's analysis has nothing to do with liquidity in real units and the real rate of interest.« The reference given to prove this stark statement seems badly chosen however: the well founded rejection of the Fisher Theorem (Keynes 1936: 142) does not imply that real interest rates are irrelevant for investment decisions.

properties of interest and money; Keynes saw this clearly. But exactly these propositions let us expect that there is rigidity of money wages and prices:

> »Price rigidity is not an appendage which can be removed without harm. Wage and price rigidity is an essential property of money, and the most successful of operations to remove it would mean the death of the patient so transformed. Any money which was completely cured of wage and price rigidity would not be able to survive as money« (Lerner 1952: 193).

Hence, there is some circularity in the argument; and the need for a *basic* rigidity of money, wages and prices surely does not rule out some limited adjustment – a ten percent reduction of money wages (again: this is not what I suggest) would not turn a monetary economy into a barter system. Therefore, the line of reasoning in Chapter 17 lends only limited support to the dynamic-adjustment arguments for the possible persistence of unemployment given in Chapter 19.

References

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The Post-Keynesian Economics Study Group – After 20 Years

*M.G. Hayes**

Foundation and Purpose

The Post-Keynesian Economics Study Group (or PKSG, as it is usually abbreviated) was founded in 1988 by Philip Arestis and Victoria Chick with financial support from the UK Economic and Social Research Council (ESRC). The purpose of the Study Group is to encourage collaboration among scholars and students of Post-Keynesian economics, defined by the founders broadly

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