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HOW DEAD IS KEYNES?*

JAMES TOBIN

The man J. M. Keynes died in 1946. But today there are frequent reports that Keynes is dead. The *Wall Street Journal* publishes them regularly. *Newsweek* has confirmed the event. Economists write books and articles in explanation. Washington, under Administrations of both colors, acts as if it believes these reports. Who or what did it? Some say other economists, with rapier logic. Some say high time. A few mourn.

Maybe the reports are true. Maybe they are wishful thinking. Maybe they are exaggerated. There is a counter-rumor that Keynes is alive and well and living in New England. The whole matter seems worth investigation. Unlike Tom Sawyer, Keynes cannot attend his own funeral. It's just as well, considering what is being said. Tom wept in grief; Keynes might laugh. I make no pretense of being his stand-in. But the cliché, only a few years ago went "We're all Keynesians now." It was reportedly endorsed even by R. Nixon and M. Friedman. So the bell is tolling for all of us.

Have events refuted Keynes? Let's recall the central propositions of the *General Theory* and ask how they stand up to current history.

First proposition: In modern industrial capitalist societies, prices and wages respond slowly to excess demand or supply, especially slowly to excess supply. Over a long short run, ups and downs of demand register in output; they are far from completely absorbed in prices.

For evidence, Keynes needed to look no further than Britain in the 1920s and the world in depression. Churchill's return to gold in 1925 made British wages and internal costs uncompetitive, but massive unemployment failed to bring them in line. During the slump of 1929-32, American wages fell sluggishly — and real wages rose thanks to the collapse of food prices — while unemployment rose from 4% to 25%. In the 1930s recovery, output and employment responded to demand.

And now? After three years of recession and slow recovery, high unemployment and excess capacity persist, while domestic price and wage inflation proceeds with little abatement. On the other hand, output and employment have responded to increased demand, while inflation has not accelerated.

Is the first proposition patently irrelevant and inapplicable today?

Second proposition, a corollary of the first, is the vulnerability of economies like ours to lengthy bouts of involuntary unemployment. People willing to work at or below prevailing real wages cannot find jobs.

*Yale University. Invited address, Western Economic Association, June 23, 1977, Anaheim, California.

They have no effective way to signal their availability.

Was this an improper extrapolation from an aberrant episode, the Great Depression? Maybe such an objection was credible before 1974. Today, is involuntary unemployment a clearly foolish concept or an obviously misplaced concern?

Third proposition. Capital formation depends on long run appraisals of profit expectations and risks and on business attitudes toward bearing the risks. These are not simple predictable functions of current and recent economic events. Variations of the marginal efficiency of capital contain, for all practical purposes, important elements of autonomy and exogeneity. But business expectation of steady prosperity is an important stabilizer of investment and of the economy, limiting cyclical instability. Likewise destruction of such expectation can turn mild cyclical recessions into periods of protracted stagnation.

This is why the recession of 1920-30 slipped into depression and became, in kind as in degree, different from preceding downturns. How about the recession of 1974-75 compared to its post-war predecessors? Even now real fixed non-residential investment remains in the doldrums, 7% below 1973.

Does this Keynesian proposition self-evidently deserve interment?

Fourth proposition. Even if money wages and prices were responsive to market excess demands and supplies, their flexibility would not necessarily stabilize monetary economies subject to demand and supply shocks. This was Keynes's challenge to accepted doctrine that market mechanisms are inherently self-correcting and stabilizing. He found the alleged demonstrations for particular markets especially unconvincing for the economy as a whole. He suggested, therefore, that it was easier to stabilize real economic variables by moving aggregate monetary demand relative to a given path of money wage rates than by moving wages relative to given monetary demand — even if the latter were a realistic option.

Experience provides little evidence on this issue. The theory of price adjustments in interrelated competitive markets is a lot more sophisticated than the hand wavings that evoked Keynes's skepticism four decades ago. But can his doubts be firmly dismissed as unjustified?

I submit that none of these four central Keynesian propositions is inconsistent with the contemporary economic scene here or in other advanced democratic capitalist countries. At least the first three fit the facts extremely well. Indeed the middle 70s follow the Keynesian script better than any post-war period except the early 60s. It hardly seems the time for a funeral.

Yet there is certainly great resistance, among economists, men of affairs, and policy-makers, to a Keynesian diagnosis of the present economic situation. Perhaps deficient aggregate demand is too simple, too old-hat, too boring. Perhaps people are afraid of the prescriptions

that might accompany the diagnosis. Some of the arguments against the diagnosis are theoretical; some are empirical.

They are all inspired by faith that the economy can never be very far from equilibrium. Markets work, excess supplies and demands are eliminated, expectations embody the best available information, people always make any and all deals which would move all parties to preferred positions. With such faith the orthodox economists of the early 1930s could shut their eyes to events they knew *a priori* could not be happening. With such faith their successors of the 1970s can tell us that the very persistence of high unemployment and excess capacity reveal them to be the voluntarily preferred state of affairs. Keynes might say this is where he came in.

It is indeed difficult to give a rationale for the observed persistence of rising wages and prices coexistent with excess supply. It is difficult to give a convincing rationale within the paradigm of utility and profit-maximizing behavior in competitive markets. Keynes's own observations on money wage stickiness have not satisfied the canons of proof of subsequent theorists. Increasingly their reaction has been, "If we can't explain this phenomenon to our satisfaction within the paradigm, then it doesn't happen."

One currently popular explanation of variations in employment is temporary confusion of relative and absolute prices. Employers and workers are fooled into too many jobs by unexpected inflation, but only until they learn it affects other prices, not just the prices of what they sell. The reverse happens temporarily when inflation falls short of expectation. This model can scarcely explain more than transient disequilibrium in labor markets.

So how can the faithful explain the slow cycles of unemployment we actually observe? Only by arguing that the natural rate itself fluctuates, that variations in unemployment rates are substantially changes in voluntary, frictional, or structural unemployment rather than in involuntary joblessness due to generally deficient demand. Search theory is an important contribution. Applied to labor markets, it helps us to understand the level and trend of aggregate unemployment in prosperous times, and the differences in unemployment rates among labor markets and types of workers. However, as an explanation of cyclical fluctuations, search models are contradicted by a number of statistical regularities: voluntary quit rates move procyclically, counter to overall unemployment; the help wanted index, our closest approach to a job vacancy series, also moves procyclically; recession unemployment contains a large component of layoffs subject to recall; most job searches and changes by adult workers involve no interruption of employment at all.

You are all familiar with evidence commonly advanced to minimize the involuntary deficient-demand component of post-1973 unemployment: the concentration of unemployment on demographic groups prone

to high turnover, the extraordinary growth of the labor force, the flood of women job-seekers, the minimum wage, the advantages of living on unemployment insurance and other doles. They simply do not fit the facts.

Demographic shift may explain an increase in the overall unemployment rate of as much as a point since 1965. Teenagers and young adults, now larger proportions of the labor force, experience higher than average unemployment rates. These can be attributed in part to turnover and search, and if not to voluntary choice then at least to structural mismatch between available jobs and workers rather than to generally deficient demand. (It's strange, however, that the structure of labor demand has not better adjusted in all this time to the actual composition of the labor force.) But the *increase* in unemployment since 1973 cannot be explained by demographic shift. The increase was concentrated on prime workers. Unemployment rates for prime age adults, for married males, for experienced workers — for every demographic classification associated with low voluntary turnover and with employer preferences — rose relative to rates for the high-turnover and structurally disadvantaged groups. Moreover, job losers rose strikingly as a proportion of the unemployed relative to job leavers and to persons entering or re-entering the labor force.

Another excuse for the persistence of high unemployment since 1973 is rapid growth of the labor force — job creation just can't keep pace. Look at the doughnut, we are told, not at the hole, look at the ratio of employment to working age population, not the unemployment rate. But the upward trend in labor force participation is nothing new, and neither is procyclical response of participation to employment prospects. In fact the growth of the labor force during 1975 and 1976 was smaller than in each of the three preceding years. And as previously noted, labor force entrants and re-entrants have not been an unusually high fraction of the unemployed.

Special attention, indeed special consternation, has been focused on the growth of the female labor force. This too is nothing new, only the continuation of a long term trend toward convergence of female and male participation rates. Women's labor force participation has risen from 38% in 1960 to nearly 50% now. No wonder Geoffrey Moore's employment ratio can be at an all-time high at the same time as unemployment rates also set post-war records. Incidentally, the use of his doughnut ratio as the criterion of labor market performance should evoke protests from both women's lib and men's lib. It implies that women who choose careers can get jobs only if they displace men.

The minimum wage, I agree, contributes to teenage unemployment. But during a period when it fell relative to average wages and to product prices, it can hardly be blamed for dramatic increases in unemployment. Likewise unemployment compensation, together with other assistance

available to the unemployed, no doubt increases the amount of voluntary and recorded unemployment. There are plenty of anecdotes and some econometrics to support the charge. But even now only half the unemployed are covered. Anyway the liberalization of benefits in amount and duration was a legislative response to the massive unemployment created by the recession; it can scarcely have caused the unemployment, and most of the emergency improvements are scheduled to vanish when unemployment rates fall.

No, the rise in unemployment was not a sudden shift in the natural rate, but a decline in the number of jobs relative to the supply of labor. Excess supply, involuntary unemployment, persist.

Along with excess supply of labor we have had, we still have, an excess supply of capital services. I have yet to hear a convincing story how the unemployment of machines and factories reflects either voluntary search — are they waiting for those lush quasirents in the upper tails of the distribution? — or revealed preferences for idleness unsubsidized by unemployment insurance or food stamps. Maybe it could be argued — Keynes himself made such an argument in his "user cost" appendix — that use of capital now sacrifices future capacity in stronger markets. The technological premise seems shaky; more likely capital services foregone today are lost forever, thanks to time depreciation and obsolescence. Anyway the argument, for what it is worth, is a reason for price stickiness in the face of temporarily low demand. It may help to explain why capacity is idle when demand is deficient. It is not a reason to attribute reduced utilization of existing capacity to an increase in the reservation price of its services. Machines are ready to work at existing quasi-rents, like labor at existing wages.

I have labored the obvious, but only because the obvious is so often denied or ignored. Failure to accept or understand the Keynesian diagnosis — demand deficiency — is especially apparent in discussion of remedies. Fiscal and monetary measures to expand aggregate demand are dismissed on grounds that would make sense only if the economy were already in full employment or natural rate equilibrium or indeed suffering from demand-pull inflation. I do not say that these are the only grounds on which expansionary measures can be or are opposed. I will discuss other grounds shortly. Right now I wish to call to your attention some examples of misplaced equilibrium arguments.

Recall the excitement, not to say panic, generated by federal deficits in 1975 and 1976. Selling all those Treasury securities would crowd business out of the financial markets and capital formation out of the economy. The argument was applied even to the passive deficits resulting from recession, but its main debating thrust was against actively expansionary fiscal policy, new spending or tax reduction. Again Keynes might say, "This is where I came in": the famous or notorious Treasury View of Winston Churchill's Exchequer in 1929 was reborn in William

Simon's Treasury. Now one does not have to be a monetarist to agree that a determined central bank can find and follow a monetary policy which cancels out fiscal expansion and makes the crowding out story true. But why should they? In an economy with under-employment of labor and capital, resources to satisfy the demands of government and its transferees do not have to be taken from other users.

But, it was said and will be said, monetary expansion is per se inflationary. Catch 22! Fiscal policy can't work without monetary accommodation. Monetary expansion can't work because it is dissipated in price inflation. At full employment, at the natural rate, this would make sense. In an economy suffering from insufficiency of demand, the Keynesian disease, it does not. More labor and capital services will be supplied, if demanded, along the on-going path of wages and prices, without accelerating their increase. Indeed for this very reason many of the opponents of expansionary *policy* have been and remain willing to accept expansions spontaneously generated. Somehow growth of M x V is innocuous and effective when it is due to V but dangerous and ineffective, both, when it is due to M. We should be grateful for small favors. Such recovery as we have enjoyed was consistent with Federal Reserve money stock targets only because of fortuitous bulges of velocity, i.e., demand for money was unexpectedly low for prevailing incomes and interest rates.

The taboo on actively expansionary monetary policy remains. Its rationale is that the public's interpretation of such policy deprives it of effectiveness. Rational, or at least reasonable, people will expect more inflation to follow from more rapid monetary growth. Interest rates and actual prices will follow the expectations upward, but there will be no gains in real variables. Is this scenario self-consistent, as the canons of rational expectations require, in an under-employed economy? The answer is negative. Nominal interest rates cannot increase by as much as the assumed escalation of expected inflation. If they did, the demand for real money balances would have declined, while the supply has risen or at worst remained constant in real terms. So real interest rates must decline, expanding real demand, output, and employment, and accelerating inflation less than the speed-up of monetary growth. Naive association of inflation expectation and monetary growth rates is not rational. Rational expectations would support a Keynes-Phillips path so long as the economy is on the high side of the natural rate. This is not to deny that if the public has been strongly and wrongly indoctrinated, irrational expectations may be an obstacle to expansionary policy.

Neither is it to deny that the public may rationally believe that more inflation leads to recession, although I think the connection is usually not well understood. Policy, particularly monetary policy, is an indispensable link in the chain. The 1974-75 recession was the result not of double-digit inflation but of the quixotic measures taken by the Fed to oppose

an externally generated bulge of specific prices. It was not the first recession generated by anti-inflationary policy. Consequently expansionary monetary policy during recovery — indeed recovery itself however fueled — may be regarded as a portent of contractionary policy to come.

Let me return to the question of the efficacy of fiscal policy. Another crowding out argument, more subtle than displacement of private investment via higher interest rates, is what is sometimes called *ex ante* crowding out. The argument is that bond-financed government expenditures cannot absorb saving, any more than tax-financed expenditures do. The ever-rational far-sighted public, it is alleged, knows that tax bills will be rendered later. Their new saving in anticipation of future tax liabilities will match the deficit. There will be no increase in aggregate demand — except, I guess, the old balanced budget multiplier effect of government purchases. It's some consolation that this time investment is not crowded out, just consumption; but financial crowding out may be piled on top since the bonds are a part of portfolio wealth if not of true net wealth. I have some problems with this doctrine even for full employment and the very long run. These concern the distributional, incentive, and risk effects of the future non-lump-sum taxes actually expected. Debt finance would, I think, crowd out capital in long-run steady states. For the same reasons it would absorb saving in Keynesian short runs.

In a Keynesian short run with under-employment, the public, even if they fully discount future taxes, can correctly calculate improvement in the present value of future real after-tax incomes. They are raised by the near term employment of otherwise idle resources. Expecting that, households will increase their spending and make the scenario come true. Failing that, they will not have to pay additional taxes anyway, in a tax system which relates tax liabilities directly or indirectly to economic activity.

Exponents of *ex ante* crowding out ignore a feature of real world economies that significantly reduces the equivalence of future and current taxes. This is the fact that capital markets are imperfect, notably in limiting the capacity of individuals to borrow against future labor income or retirement pensions. Consequently many households are at any moment liquidity-constrained. Their spending will be increased if the government allows them to defer tax payments.

In short, Keynesian diagnosis still applies to situations like the present, and latter-day macroeconomic theory has not rendered Keynesian remedies obsolete.

I said earlier that there are other reasons for opposing such remedies. The over-riding motive is to keep the economy under-employed while the hard-core built-in inflation melts. In Keynes's day the stubborn wage price pattern was one of wage stability with moderately declining prices — what Hicks would call the flexprice sector was relatively much larger. Today our mutually reinforcing wage-price pattern, inherited

from the past decade, is roughly 8% wage inflation and 6% price inflation. As in the past, shocks can move it up or down, and those who regard the present inflation rates as intolerable don't want to take any outside risks. These are the substantial reasons for the go-slow recovery policy of our government since 1974.

The go-slow policy is terribly expensive in irretrievably lost output. Fifty billion dollars for every excess point of unemployment — that ain't peanuts. Suppose that the policy succeeds in restoring 5% unemployment in 1981, while, thanks to its gradualism, inflation falls by a couple of points in the process. We will have taken six years to recover from a 15-month recession, with output losses I would find impossible to justify on any pragmatic cost/benefit calculus. But I will not argue that case this afternoon. More germane to my topic is the unlikelihood of achieving those modest goals.

Sustained and complete recovery depends on business investment. But the long delayed revival of investment depends on confidence in sustained and complete recovery. Prospective capacity bottlenecks and sectoral price pressures scare the inflation-conscious authorities and their watchful constituents. But without confidence in future sales and profits and without receptive markets for corporate debt and equity, investment to avert the putative bottlenecks is not undertaken. The Fed announces lower monetary targets and promises to lower them further until they accord with zero (not 4%) inflation. The specter of collision between those targets and the economy's inflationary momentum hangs over the recovery. When and if they collide, everyone knows in his bones, it is output not prices which will give way.

Many economists and policy-makers hoped, some even expected, that wage and price inflation would adapt to well advertised monetary targets. Let labor and industry know their monetary rations and choose how they wish to divide them between real growth of output and employment and inflation of wages and prices. One current academic theory is that labor markets will clear as rapidly as contracts expire and are renegotiated, or whenever non-union employers reconsider administered wage scales. Disequilibrium lasts only as long as the parties are frozen into past errors of expectation. With faith in both market efficiency and rational expectations, these theorists may declare confirmation by tautology. But the evidence suggests to me that the momentum of wage patterns carries beyond the duration of formal contracts or budgets from contract to contract, from this year's administered wage increase to next year's.

Other inflation hawks, like my respected friend and former colleague William Fellner, regard the control of inflation as a war game. On one side are the forces of altruistic discipline, the monetary authorities; on the other is the shortsighted unruly economy. What is needed, they say, is a clear and resolute declaration that inflationary wage and price behavior

will not be ratified by accommodative monetary policy — lock in the money supply and throw away the key. This, they argue, will yield more dramatic and prompt disinflation than anyone's econometric equations, estimated from past observations, would forecast. Isn't this what Arthur Burns has done, without spectacular results? Fellner and others would answer, I paraphrase, that the threat has not been credible enough precisely because Keynesian economists and politicians undermine it by advocating accommodation. In similar vein, two Presidents complained that they could win the war in Southeast Asia if only political opposition at home would cease to impair their credibility to the enemy. The analogy underscores the difficulty of the threat approach in a democracy. In any case, I do not see how, in our decentralized system of wage- and price-setting, there is any incentive for a firm or union or individual worker to be the first to de-escalate. I note also that when Dr. Burns disciplines his class for inflationary offenses, the innocent are punished more than the guilty. Even after the punitive recession OPEC is ahead of the game.

Is there no alternative? Must we *either* hold the real performance of the economy hostage to disinflation *or* accommodate monetary demand to the inflation that history happens to have bequeathed us? Our quandary today is a vivid example of the general dilemma I mentioned at the beginning: Hew to a noninflationary line of monetary demand and rely on market forces to produce a compatible and stabilizing path of wages and prices? Or, as Keynes was advocating in the 1920s and 1930s, adapt the course of monetary demand to the wage-price trend. The first, experience suggests, often gives poor performance in the real payoffs of economic activity. The second leaves prices unanchored, their path the cumulative history of random shocks.

The way out, the only way out, is incomes policy. In 1961 the same dilemma, on what seems in retrospect an incredibly less provocative scale, inspired the "guideposts for noninflationary price and wage behavior." In the same retrospect they may even deserve some credit for the inflation-free recovery to 4% unemployment completed prior to the fiscal disaster of 1966. Those guideposts were advisory. But similar standards could be given, if not teeth, at least some carrots and sticks. Use corporate, personal income, and payroll taxes to reward and insure compliant employers and workers, and possibly — as Wallich and Weintraub independently proposed — to penalize violators.

Proposals of this kind, avoiding the straitjackets of full-blown controls and the futilities of unassisted open mouth operations, deserve much more professional and public attention than they have received. Unfortunately, thanks to Nixon's ventures into wage-price control, incomes policy of any kind is unpopular today. It is especially unpopular with the same economists and opinion leaders who place the highest priority on the conquest of inflation. Any economics student can expatiate on the inequities, distortions, and allocational inefficiencies of controls or guide-

posts or tax rewards and penalties. But just consider the alternative. The microeconomic distortions of incomes policies would be trivial compared to the macroeconomic costs of prolonged under-employment of labor and capital. It takes a heap of Harberger Triangles to fill an Okun Gap.

A final footnote will bring us back to Keynes. As I reminded you earlier, he was appalled by Britain's return to gold in 1925. He was further appalled by the government's failure to take any direct action to bring internal wages and prices into line with the new exchange rate. Later, after the *General Theory*, he recognized that some direct wage/price policy would be needed if the economy were stabilized near full employment.