KEYNES LECTURE IN ECONOMICS

HOW USEFUL ARE KEYNESIAN IDEAS IN THE 1980s?

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THIS subject is obviously a vast one, and I cannot possibly treat it exhaustively. Since I chose the title, I cannot of course justify my incomplete treatment on grounds of the subject's vastness, and I will confess that when I fixed it a year ago my primary objective was to give myself an 'umbrella' to cover many possible ideas which might occur to me over the coming year. But the question I have chosen is clearly *important*, and even a partial answer should be helpful.

I would like to start with a blunt statement of the main points which I wish to put before you, without much attempt at justification. This procedure seems to have two main advantages:

(*a*) The economy of the real world is a hideously complex affair, with all sorts of interactions between its components. A detailed treatment which starts from the components suffers from impossible conundra about where one should begin, because each one is affected by others which will be discussed later: 'begin at the beginning, go on to the end, and then stop' is not a very helpful guide to the aspiring lecturer on real-world economics. A brief overview at the beginning should help the listener to see how the parts fit together as they are described.

(*b*) I would not feel in proper contact with my audience if I simply *read out* the lecture which will appear in the Proceedings; but the extra spontaneity which one gets from following the inspiration of the moment is apt to play havoc with any preconceived ideas about *timing*. Hence I adopt the good journalistic rule, impressed on me as a member of the Royal Commission on the Press: start with what you regard as the essentials, however illogical the order may then seem, because sub-editors simply cut from the bottom. The end of the lecturer's hour does the same thing.

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Conclusions in Brief

The basic points which I would like to establish are, then, as follows:

(1) Governments should reject the fashionable view that they have no real power to influence output and employment by influencing demand. They should, however, recognize that their macroeconomic policies have to be concerned with other things as well, and that they must consider *future* levels of output and employment as well as this year's. Moreover, they should also recognize that on occasions it may be necessary to *reduce* demand if the economy is overheated: 'How to Pay for the War' provides lessons, as well as 'The Means to Prosperity'.

(2) Nevertheless, governments should not be too ambitious in their objectives in this field. They have to recognize the great difficulties caused by the non-static nature of the economy: 'fine tuning' is not likely to be successful in a world beset with time-lags and exposed to international and other shocks, especially when people in other power-centres are also moving *their* controls. And governments normally have *other* objectives which may conflict with those of immediate output or employment—perhaps long-term growth, or greater economic equality.

(3) In formulating their macroeconomic policies, governments *will* find Keynesian ideas useful, but they have to recognize the need for other ideas as well—notably on how to influence prices and incomes. Moreover, in choosing between various instruments which Keynesian ideas might treat essentially as *alternative* ways of influencing demand, the varying contributions which those instruments make to *other* objectives may be decisive.

Objections to Keynesian Ideas

(4) The objection that Keynesian expansionist policies, if used by themselves, may produce progressive inflation has to be taken seriously; but this should be a stimulus to the search for effective accompanying policies, not a reason for abandoning expansion. We should decisively reject the idea that moderate, non-accelerating inflation is such an evil that it rules out policies which produce higher and more rapidly rising real output.

(5) The objection that Keynesian remedies have been tried and have always proved a failure is simply untrue. It is sometimes advanced in relation to the post-war experience of the UK economy in the thirty years before the Thatcher Government: yet this was a period in which UK economic progress, in real terms,

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was far better than in any earlier period of our history. I have dealt with this topic in my chapter in a recent book edited by Shepherd, Turk, and Silberston and I must not spend time on it here. Let me merely say three things:

(*a*) The performance was superior in such 'hard' fields as exports and capital formation, not just on consumption.

(*b*) Even in the last decade, which was much less satisfactory, real GDP grew faster than in any decade before the Second World War.

(*c*) The idea of a 'poor' performance by the UK rests wholly on the fact that other countries did *even better*.

(6) Another reason for claiming that Keynesian ideas have always failed is reflected in such statements as 'the improvement in our competitive power produced by the 1967 devaluation was all lost by 1972'. This approach seems to rest on the naïve view that a 'remedy' is only acceptable if, after its application, one can say 'and so they lived happily ever after'. That may seem natural to theorists who write about an imaginary world in which free market forces automatically produce 'equilibrium', but in the real world new difficulties arise which require further macroeconomic action. Of course it is desirable, if one sees that forces exist in the economy which are likely to make a problem recur, to find a method of removing or restraining those forces, *if* this can not only be done, but be done without producing 14 per cent unemployment. But this is likely in practice to require a continuous policy of (say) 'joint economic assessments', rather than simply a single act of changing the law on trade unions.

(7) Another objection which is frequently raised is that although *in theory* demand management offers the possibility of great rewards, yet *in practice* the difficulties of applying the policy are so great that it is best to adopt some simple and easily understood rules of behaviour, and stick to them. In effect, the argument is that a Keynesian policy ought to be based on a view of what *will* happen in future, and in practice the policy-maker is likely to be defeated by changes in exogenous factors, delayed effects of past actions, obsolete data, and time-lags between a decision and its effects.

I confess to some sympathy with the idea underlying this view. In advising underdeveloped countries, I regularly find myself stressing the point that they should not go in for state intervention unless they feel reasonably assured that it will produce beneficial results *in practice*, after allowing for the administrative problems. And in a much humbler capacity I have found the principle

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invaluable in helping to manage Clare College's investments over the last thirty years; we have stuck fairly faithfully to the principles of having a portfolio which roughly reflects the pattern of equities available on the Stock Exchange, and making changes only once a year. These self-denying rules against 'trying to be clever' have proved surprisingly successful: on an accumulating basis, the Clare accumulation is now worth well over four times the notional 'control' unit based on the *Financial Times* index.[1]

My conclusion is not, however, that policy-makers should simply retreat into a policy of aiming for a growth in the money supply of 4 per cent per annum, 'come wind, come weather', and letting the economy look after itself: nor would I wish them to follow a wholly mechanical policy of some other (more pertinent) kind. It seems to me necessary that they should make some attempt to assess the economic conjuncture and adapt policy to it: but I would advocate rather modest targets for what state action should try to achieve, and a resolute refusal to let policy be buffeted about from month to month by the latest news.

(8) A further objection is sometimes raised that Keynesian ideas might be excellent for a closed system, but are of no use for an open one. This seems to be basically misconceived, at least for an economy as large as the UK's. Certainly the problems are more complicated, and one needs (to my mind) to have an exchange rate *policy* of a fairly positive kind—but the need for purposeful action is all the greater.

I would like to say a lot more about the international side of things, but time does not permit. Let me just emphasize two points:

(*a*) Keynesian ideas are highly relevant if one is attempting to secure international co-operation to get out of the current world recession;

(*b*) We should avoid the text-book habit of portraying international factors as always making life more difficult (because we may import a depression or an inflation from the less enlightened countries in the rest of the world). The fall in UK inflation in 1982 owed much to the fall in world prices for primary commodities; let us hope that expansion in USA will help to raise UK output in 1983/4.

(9) Finally, there are three Keynesian ideas which I regard as deceptive. First, decisions whether or not expansionist action should be taken (and how *rapid* an expansion should be sought) need to be considered in terms of *the potential increase in output*,

[1] Our experience up to 1978 is set out, and discussed, in *Macro-economic Analysis*, edited by Currie, Nobay, and Peel (Croom-Helm, 1981).

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rather than in terms of unemployment. Secondly, the Keynesian assumption that holding money brings no interest, but only 'convenience', is totally out of date, even as an approximation, in an age when the newspapers are filled with advertisements from institutions offering both 'immediate access' and high interest. And thirdly, the idea that it is easy for the authorities to determine the rate at which the quantity of money grows is also out of date, even though it was used brilliantly for securing the War Loan conversion in 1932; it is of course monetarists rather than Keynesians who need to take most heed of the changed nature of the money market.

Prices, Wages, Employment, and Output

Having set out my major conclusions, I wish now to consider more systematically why doubts have been expressed about the usefulness of Keynesian ideas, and why I feel that these should not lead one to abandon the ideas, but rather to complement them with some further elaborations. This would again call for a large book rather than a single lecture, so I shall attempt no refinements.

The Counter-revolution

In its essence, the counter-revolution rests on the simple proposition that even when there is substantial unemployment, measures to raise the level of demand (expressed in money) will only briefly affect the level of output, and will then lead simply to a higher rate of inflation.

An alternative way of saying much the same thing is to assert that the economy is self-adjusting to a level of real output which depends on 'real' factors, and that attempts to raise output above that level by demand management will simply produce higher inflation.

A corollary is sometimes drawn that everything really turns on the quantity of money, with government finance being of little importance except in so far as its management affects the ease with which the quantity of money can be induced to expand at the rate desired by the government. Protagonists of this line of thought, however, sometimes argue that the monetary management determines the rate of growth of *money GDP*, with the division of the increase between *prices* and *output* being determined by some other force (e.g. trade union policy).

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Keynesian Ideas and Price Movements

A whole body of literature has been built up about how Keynes analysed the relationship between demand management and prices. I do not feel able to pursue the matter here, but much of what people think of as Keynesian analysis, especially that which is related to policy issues, seems to be conducted in terms of variables measured in real terms, with little reference to price movements. Keynes did, of course, produce an analysis which showed that, on admittedly strong assumptions, one can deduce that so long as one is below 'full employment', an increase in the quantity of money will have no effect on prices; but as soon as full employment is reached, the wage-unit and prices will increase in exact proportion to the increase in effective demand.[1] Much analysis seems to be implicitly based on this premise, or something like it, with the 'strong assumptions' conveniently forgotten. The matter is further complicated because in much of the *General Theory* Keynes is effectively measuring many variables in terms of wage-units (roughly the amount of money paid for an hour of 'ordinary labour'), and there is no formal analysis of what causes changes in the wage-unit.[2] The critics' charge is, then, that this procedure is illegitimate and destroys the whole analysis.

It seemed useful to look briefly at some of my own writings, as a sort of test case, to see what I was implicitly assuming.

First, there are two articles where I was essentially concerned with studying the behaviour of real variables. In 1936 I wrote a review of the *General Theory* for the *Economic Record*; and in 1963 Robert Lekachman included that review in his collection entitled *Keynes' General Theory: Reports of Three Decades*, along with a new article in which I was largely concerned to show that Keynesian analysis had to be conducted on the basis of explicit assumptions about government policy.[3]

[1] See *General Theory*, p. 295.

[2] On p. 301 of the *General Theory* we find the following: 'That the wage-unit may tend to rise before full employment has been reached, requires little comment or explanation.' On p. 247 the second of three 'ultimate independent variables' is set out as 'the wage-unit as determined by the bargains reached between employers and employed'; but this process is not analysed.

[3] My review had ended with the famous quotation from the *General Theory*: 'A decreased readiness to spend will be looked on in quite a different light if, instead of being regarded as a factor which will, *ceteris paribus*, increase investment, it is seen as a factor which will, *ceteris paribus*, diminish employment.' My new contribution showed how for six fairly plausible interpretations of what *ceteris paribus* implied about Government policy, the outcome varied quite fundamentally.

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Prices and the wage-unit hardly featured in either of these articles. This did not necessarily imply that they were assumed to be stable, but only that the analysis of the real variables could be conducted without serious attention to them. This view might perhaps be justified on the following implicit assumptions:

(*a*) The effect on prices of the policy instrument under discussion was assumed to have negligible repercussions on the real variables which were being considered, perhaps because the policy instrument (e.g. a change in the quantity of money) was assumed to be adjusted in size to allow for any change in prices.

(*b*) Prices might also move for exogenous reasons (e.g. a bad harvest), but everything was to be taken as measured in real terms.

On the other hand, when I have been concerned with price-movements as such, I have naturally adopted a quite different approach. My most relevant article appeared in *Lloyds Bank Review* for July 1966, entitled 'Rising Prices for Ever?', but it embodied and elaborated evidence given in 1957 to the Council on Productivity, Prices, and Incomes (the Cohen Committee). This article was very much concerned with changes in the wage-unit, which it expected to be so persistently upward in the UK that the question-mark in the article's title could be deleted: the best forecast was that we *would* experience rising prices for the indefinite future—a prediction, I may say, which subsequent events have done nothing to make me change.

The reasons for this conclusion can be very crudely summarized as the *combination* of cost-push forces with a Government pledge to seek 'a high and stable level of employment'. The article duly considered the pure 'demand-pull' explanation for rising prices (and consequent rises in wage-rates), on the assumption that this had no support from sectional monopolistic forces on the supply side: it concluded, however, that in the case of the UK such an explanation would have been—to say the least—incomplete. The conclusion about ever-rising prices rested firmly on the continuation of cost-push forces, the strength of which was influenced not only by the *current* level of demand, but also by *past experience*: a sustained period of 'full employment' leads union bargainers to be more demanding, and employers' representatives to be more optimistic about passing on the higher costs caused by a 'generous' settlement, and more reluctant to face the costs of a strike.

For the analysis of inflation, the key point is clearly the settlement of wages by collective bargaining, and here it is, to my mind, crucial to emphasize the familiar point that this is done

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sectionally, for separate groups of specialized workers. Keynes's wage-unit is a convenient device for many purposes, but it is not settled by a single collective bargain: it is the almost accidental statistical outcome of a host of separate bargains, where the parties concerned are motivated by different forces from those which would apply if there were a single, national bargaining-table.

Basic Analysis

This point is so important—not only for prices, but also for output and employment—that it deserves a little elaboration at a rather basic level.

In a modern economy, production of each article depends on the co-operation in a factory or other establishment of different classes of people, who supply labour of various specialized kinds and also many sorts of capital equipment. In addition, it is essential that the teams which produce the various articles shall 'co-operate' with each other, both by supplying, through the market, a host of specialized intermediate products for use by the other teams and also by supplying the general market with adequate amounts of finished goods. This intricate system of co-operation requires that the terms on which each person supplies his services, or those of his property, shall somehow be settled in an acceptable way. If this cannot be done, then production will not be carried out, even though it is clearly in the collective interest of the community that it should be.

The 'classical' or 'text-book' solution of this problem postulates that each individual supplier of a particular commodity or service will compete freely with other suppliers of that item, and also with suppliers of other items, and that everyone will accept the verdict of the market-place as to the price which he receives—though he is, of course, free to decide to change to supplying something else, or nothing at all. Naturally, it is recognized that the real world does not conform exactly to this simplified model, but the departures are considered negligible (except in the very short run) by those economists who believe in a simple 'market-clearing' assumption, with all its beneficent theoretical results. More pragmatic economists assume that the divergences do not prevent some sort of working 'solution' from being attained through the market mechanism, though it is likely to include some inflation as a 'lubricant', and certainly cannot be guaranteed to give 'a high and stable level of employment'. The sections of the community which are ill organized for bargaining or lobbying used to be assumed to produce much of the necessary flexibility; but with

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indexation and other institutional changes this explanation has become less convincing.

At the risk of labouring the obvious, it is clear that if each specialist group, including the employers in each industry, acts as a unit and 'demands' certain rates of real income on pain of a mass withdrawal of its services, and if these claims add up to more than the total output, then a break-down is inevitable—unless, of course, some groups give way.

Fortunately the institutional mechanism is not so rigid as that. Collective bargaining does not fix a real wage, which must apply until the next bargain. A wage-agreement is fixed in money, for a year (or other substantial period), and its initial value in real terms is likely to be progressively decreased, to an unknown extent, by the actions of absent parties, such as the suppliers of consumer goods or the tax-gatherer. Moreover no agreement is reached about the level of profits, or about the extent to which the employers may recoup higher wages by charging higher prices to another absent party—the consumer. If the bargaining really had to reach an agreement about the level of real wages and about the division of a cake of known size between the workers and employers, the risk of breakdowns would be much greater. It would be wrong to lay much emphasis on money *illusion*, but agreements are helped by the *certainty* of the immediate gain which they bring to the workers (as compared with yesterday) and by the thought that if this is too drastically eroded by rising prices, there will be another bargaining session in a year's time. Similarly the employers, who suffer an immediate increase in costs, not only escape the threat of a damaging strike, but also have at least the chance of recovering these costs in the course of the year, and can reckon on being tougher next year if they fail. Once again, it is important to recognize that each bargain is only one episode in a continuous chain of bargains. Simple-minded ideas about profit-maximizing tend to treat the outcome of each bargain as if it were to go on for ever: agreements would be much harder to reach if each side thought it was a case of 'and so we will live happily (or *un*happily) ever after'.

Policy Implications

The last section has been considering some consequences for inflation of the fact that we do not live in a world of atomistic competition. We need now to consider the implications of this simple fact for *real* variables.

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A Self-Adjusting Economy?

First, a very brief word about the theory of the self-adjusting economy. Strictly speaking, this theory seems to me to require not merely that there should be atomistic competition in the *labour* market, but also that all the millions of separate goods (and services) which are produced should be sold in perfect markets; moreover such markets need to exist for all transactions which people might wish to make, including transactions for future delivery. Under these circumstances, the assumption which seems to me basic for a self-adjusting economy would hold: that each would-be buyer or would-be seller of anything could deal on whatever scale he liked, at a market price which was independent of his actions.

Since these conditions clearly do *not* hold it becomes a matter of empirical observation to see whether or not we get acceptable results from applying policies based on the assumption that they *do*: do we, for example, get something like the predicted results, with only the sort of minor discrepancies and lags which 'frictions' can be expected to produce?

Quite bluntly, the observations which I have made do not support this hypothesis. The 'Thatcher experiment', for example, has shown that it is possible to reduce the rate of inflation to 4 per cent per annum, if you happen to have an output of North Sea Oil conveniently growing apace during the experiment (so that you can use an over-valued pound to keep prices down without getting into balance of payments difficulties), and if you are prepared to create a serious slump;[1] but even if one regarded such a result as 'acceptable', there is no evidence that inflation will stay at that level if an increase in demand raises the level of employment, whether that increase comes from Keynesian measures, or a spending-spree by consumers, or some more 'respectable' source like a big rise in the world's real income.

At a more intellectual level, there is also the question of how believers in the 'self-adjustment' theory consider that budgetary and monetary policies should be determined, since these can hardly be left to 'market forces'—even if one is prepared to declare a policy of 'benign neglect' on the exchange-rate.

A More Realistic Policy

A government which does not believe in the theory of the self-adjusting economy, and wishes to pursue a positive policy,

[1] See my article 'The Government's Economic Policy—An Appraisal', *Three Banks Review* (December 1982).

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needs to use the various instruments available to it with a view to getting satisfactory results in a number of fields, including output growth, inflation, and the balance of payments. Because of the lags involved and changing circumstances (so far as it can foresee these), it needs to have regard to the *future* results in these fields, as well as the immediate ones; and because so much is uncertain (including the way that people will react, as well as possible exogenous changes) it should not be too ambitious in what it attempts to achieve, and should try to keep a certain continuity in its actions. And finally we may note that different governments may well have different value-judgements about the weights which they attach to the various objectives.

That may well appear a very formal and unrevealing statement, although I shrewdly suspect that it is still not wide enough to cover all the possibilities. We need to look behind it to see some of its important elements.

First, it is necessary for a government to consider *both* output (and other real variables) *and* prices or wage-rates as part of one operation: the sort of schizophrenia revealed by my earlier writings is no longer acceptable, even if it ever was.

Next, the decision-taker needs to see the problems in terms of *movements through time*, not the search for a single once-for-all solution: the four equations given in my review of the *General Theory* (and approved by Keynes) showed how the four variables mutually determined one another, but the analysis was essentially static, with no discussion of how that position might be reached. A decision-taker should rather adopt the 'scenario' approach, whereby the probable results under different strategies are assessed over a period of years: he is not, of course, committed to the precise use of his instruments in the way specified for all that period, because (for example) exogenous factors may change in unpredicted ways, but the scenarios should be designed to illustrate the probable results with different strategies. The 'base-line' scenario will normally represent a continuance of present policies, so far as that can be defined.

Assessments of the scenario type necessarily have to take heed of the scale and speed of the response to be expected from British suppliers. This is influenced not only by available labour and capacity at all stages of production, but also by the outlook and finance of the entrepreneurs: at present, for example, it is said that industrialists have spent so much on redundancy payments to *reduce* their labour force that they would be very unlikely to *increase* it again at all rapidly, unless the rise in demand persisted for some

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months—by which time it would have been met by imports from Japan.

Next, there is the question of how to weight the objectives. This is of course a value-judgement, and I would only wish to insert my own strong belief that improvements on real variables are much more important than a reduction of inflation, *unless* one is in danger of getting into the zone of seriously accelerating inflation. Inflation undoubtedly brings some inconveniences and inefficiencies and, if it is not reasonably well foreseen, it brings arbitrary distributional shifts of wealth. But in itself its main consequence is that people receive a bigger money income (e.g. as wages or as pensions) than they did last year, and pay correspondingly higher prices: as a nation we suffer no real impoverishment through inflation as we do through mass unemployment—though we may lose through the forces which produced the inflation (e.g. dear oil in 1973), and if we let it get out of hand it can disorganize production.

Next, there is the crucial question of the government's 'instruments', about which again a whole book might be written. Here let me stress that budgetary policy, monetary policy, and a willingness to vary the exchange reserves are policies under which the government operates largely *through* the market by bringing in the authorities as buyers or sellers (the taxing power is an important exception); administrative *controls* of all kinds (on hire purchase, or exchange transactions, or what not) endeavour to use the government's powers to restrict the ways in which the units in the market may operate (but leave them otherwise free to make their own decisions); but *incomes policies* are largely designed to influence the actions of other 'power centres' (e.g. trade unions), which impose their own regulations on the actual operators in the market (e.g. the worker who might be prepared to take a job at a lower wage—or perhaps demand more—if he were indulging in atomistic competition). A government needs to recognize that, whatever the formal constitutional position may be, it cannot in practice simply impose its views on the other power centres, but needs to proceed at least in part by consultation, reasoning, persuasion, and even bargaining if it is to secure important results.

A government cannot avoid having a budgetary policy, a monetary policy, and a policy on exchange reserves. It may however decide to have little or nothing in the way of administrative controls or incomes policies—though it is noteworthy that although the Thatcher Government in 1979 gloried in its declarations that it left wage-fixing entirely to the judgement of

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the parties concerned, yet in later years it kept up a continuous stream of exhortations in favour of 'moderation', as well as attempting to enforce a strict policy on public sector pay.

So far as budgetary and monetary policies are concerned, it seems to me best to look *primarily* to budget policy, which is more predictable in its quantitative effects, and which offers enormous variety in the different shapes which it can take: there can be variations in *expenditure* (especially on capital account), or in *indirect taxes* (which have a special effect on the RPI), or in *direct taxes* (which may have a big effect on investment by companies for very little immediate cash loss if they imply *future* gains). Most certainly budgetary policy should not be assessed in terms of a single figure for the Public Sector Borrowing Requirement, which is of little meaning without an analysis of its composition; experience has also shown that it offers abundant scope for the operations of Goodhart's law in the treatment, for example, of council house sales, or leasing by the nationalized industries.

Monetary policy should be considered in the light of its effect on making it easier or harder for the state to finance its desired budgetary policy and the private sector its capital expenditure. *Monetary targets* as such should either be abolished, or declared in such an anaemic form that the authorities are always free to explain that departures from them are due to technical factors, such as changes in the desires of wealth-holders to hold money, or the invention of new devices to cause figures on the old definition to mean something new (Goodhart's Law). Experience since 1979 has shown both that it is hard to hit whatever arbitrary target has been proclaimed, and hard to know what result will follow if you do: but that does not mean that *monetary policy* cannot be used to reinforce fiscal policy, being guided by an assessment of the variables which are really important (including movements in wages and prices).[1]

The Present Position

Discussion of this sort of thing in general terms tends to be both dull and a bit hard to follow. As with many things—such as income-tax guides—it is the concrete example which really makes the subject come alive, and in this instance the obvious example to take is the present position in the UK. It has the special advantage for me that I can refer those who want more detail to a *written* treatment to amplify my oral exposition, since I joined with Sir

[1] A government which wished to restrain price increases without influencing real demand might cut indirect taxes but tighten up its monetary policy.

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Bryan Hopkin and Marcus Miller in publishing 'An Alternative Economic Strategy' in the *Cambridge Journal of Economics* for March 1982.

The present position is clearly one in which output is well below its present potential, even allowing for the loss of capacity and manpower-training which three-and-a-half years of squeeze have caused: one cannot judge simply from the number of unemployed (which must be over four million if one includes people who would want to take jobs if the labour market were more encouraging, but have disappeared from the official statistics because they have abandoned what present policies have turned into a hopeless search); but in most industries more orders would certainly lead to more output, as the CBI surveys clearly show. Moreover if industrialists were given good reason to expect a sustained and progressive rise in demand, the obstacles on the supply side (plant, trained labour, organization, finance) would be tackled, and a progressive increase in output would be possible over the coming years, to follow on from the initial rise. The case seems therefore very strong for a package of measures to increase demand, but one has to consider possible constraints, notably in the field of prices and wages.

In view of the desperately low level to which 'true' profits (*not* those based on historical cost) have fallen, it would be thoroughly desirable that the rise in output should be accompanied by some recovery in profit margins, over and above the improvement which a fuller use of capacity automatically brings, and this would be likely to occur. The crucial question is whether the improvement in profits and the increased demand for labour would also stimulate an increase in the level of wage-settlements.

This is where a development of Keynesian ideas is so important. If the increase in demand is largely produced by *cutting indirect taxes*, this lowers prices relatively to money wages, and so reduces the pressure for higher wage-settlements. Predicting the outcome of wage-bargaining is not, of course, an exact science, and some people have argued that the improved inflow of orders would nevertheless lead to higher settlements, because it would lower employers' resistance to wage-demands. From the employers' view-point, however, the present low level of profits and the surplus of labour available relatively to the number needed to cope with orders should, on pure supply-and-demand grounds, be pointing to wage-*cuts*, even in money terms. The fact that settlements have typically been (say) *plus 6 per cent* rather than *minus 10 per cent* is quite illogical in terms of pure competition, and

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reflects the way that bargaining works when prices have been rising. It seems unrealistic to visualize the employers agreeing to a higher settlement than 6 per cent merely because their view of the 'logical' outcome has been changed from minus 10 per cent to minus 5 per cent—especially if the price rise is being mitigated.

Thus so far as internal factors are concerned, we are in an exceptionally favourable position to justify measures which, in the first instance, would substantially increase the budget deficit, even though we have nothing in the way of an agreed incomes policy. This 'favourable position', however, simply reflects the depth of our present slump, and the severity (on a cyclically adjusted basis) of our present budget: if demand were expanded further in a year or two's time, the danger of provoking a rise in settlements would be much greater—even if there were a further cut in indirect taxes. Moreover by that time there would be a strong case for giving more of the expansion in the form of increased capital expenditure of a desirable kind, which takes time to get going, but for which preparations ought to be started immediately. Hence the 'Alternative Strategy' urged that preparatory steps should *also* be taken immediately to find out how a better system of pay determination could be introduced in a year or two's time, as part of a better and more truly democratic system for administering macroeconomic policy.

What, then, of possible *external* constraints? Will expansion simply lead to balance-of-payments problems, if it is induced by Keynesian measures?

The picture here is a bit confused, but the answer seems to be fairly clear. Thanks to the growth of North Sea oil output and a policy which has nevertheless given Britain a much worse slump than other OECD countries, the UK has had a series of balance of payments surpluses on current account, in spite of allowing the exchange rate for the pound to rise to absurd levels (and so contribute powerfully to the 'excess' slump); the worst of the exchange rate madness has been allowed to fade away, but the IMF index of relative labour costs still shows a loss of competitiveness compared with 1978 of over 20 per cent. A policy of expanding demand in the UK should help to get the world out of its slump as well as ourselves, and the UK is clearly well placed to be one of the leaders in this process: it should be accompanied by a policy of nudging the exchange-rate down a bit further, towards a level which is more realistic in terms of competitive power. This would not be a beggar-my-neighbour policy aimed at raising employment in the UK by running a balance-of-payments

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surplus, though it would help a bit directly to raise output by averting a deficit; its basic purpose would be to help to justify the expansion measures, which are in everybody's interest.

But what about the effect of the decline in sterling on the retail price index? Will not this upset the argument about wage-settlements being unaffected?

Here I must refer you to the detailed calculations set out in 'The Alternative Strategy'. With our somewhat arbitrary set of proposals we were pleasantly surprised to find that, if wage-settlements were unaffected, the RPI would actually be *lowered* by 2.4 per cent in comparison with its level under the assumed government policy, because the tax-cuts outweighed the effects of exchange depreciation and higher profit margins. We therefore concluded that it was perfectly reasonable to assume no raising of wages.

Finally, let me end with a quotation from 'The Alternative Strategy' in which I tried to catch, as I wrote it, the spirit of Keynes as he wrote 'The Means to Prosperity'. I had tried to explain why an expansion strategy could not be expected to do *more* to produce an immediate reduction in unemployment; and I went on:[1]

Why no sacrifices?

Other readers may take the opposite view: can it really be possible to have 'gains for everybody', with nobody apparently losing? Can we have simultaneously higher output and less inflation; or higher employment and a rise in average real take-home pay; or a big gain in real profits and also in real wages; or substantial fiscal concessions (on expenditure as well as tax-rates) and no serious rise in the PSBR; or a slightly improved balance of payments and enough imports to support a higher GDP?

The answers to all these questions are really simple: the standard with which we are comparing 'our' results is an extremely miserable one, with more than three million recorded unemployed and real GDP 6% below the 1979 level (despite a higher output of North Sea oil). Moreover, the government's obsession with trying to keep down the PSBR, even in a slump, has largely prevented the effect of the slump showing up as a worsening of the *government's* income-expenditure balance, and forced it onto companies and individuals. It has even, as described above, led to direct increases in inflation through high indirect taxes and high nationalized industry prices.

It seems remarkable that one should *still* have to preach the wisdom of expanding demand in a slump: it has been rightly said in another connection 'there is nothing to fear but fear itself'.

[1] See *Cambridge Journal of Economics* (March 1982), p. 90.

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