

KEYNES LECTURE IN ECONOMICS

A KEYNESIAN VIEW OF
THE STAGNATION OF THE 1980s

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I APPRECIATE more than you can know the honour you have done me by inviting me to deliver the Keynes Lecture of the British Academy this year, an honour the greater because I am the first foreigner to give the lecture. I began studying economics as a Harvard undergraduate the year in which *The General Theory* was published. My young tutor suggested we read 'this new book from England' for tutorial, and I was too young and ignorant to know that a beginner could not possibly understand it. So I plunged in, and Keynes hooked me on economics. Macro-economic models—the micro/macro jargon had yet to be invented—were fun for any young mind that liked puzzle-solving; the book persuasively prescribed simple remedies for the Great Depression, the source of the frightening political perils of the 1930s; and a crusade against the wilful blindness of a theoretical orthodoxy was exciting and inspiring for an 18-year-old. Mine is the first generation of economists who grew up Keynesian. Like most of my American contemporaries, I knew John Maynard Keynes only by reading his words. Like many of my contemporaries, I have spent much of my career teaching, interpreting, elaborating, and amending the economics of *The General Theory*.

Today, half a century later, world economic conditions bear disconcerting resemblance to those of the Great Depression, which provoked Keynes's heresies. In most of the economically advanced capitalist world, including Britain, unemployment has been very high and, usually, rising for six years or more. Compared even with the 1970s, *a fortiori* with the years before 1973, the 1980s have been hard times to which no end is in sight. How would Keynes react? What would he say of the complacency, resignation, and, yes, pride with which the political, business, and financial leaders of depressed economies view the stagnation

over which they preside? What would he say of the perverse, though orthodox, financial policies to which they stubbornly adhere, policies reminiscent of Ramsay MacDonald, Heinrich Bruening, and Herbert Hoover? What would he say of the empty but self-congratulatory economic summit meetings of the leaders of the seven major economies?

Those questions answer themselves. As we all know, Keynes was an intensely pragmatic activist, sure that there must exist a rational remedy for any obvious social evil. Like almost all economists, he was allergic to any situation that was clearly far from Pareto-optimal, where the collective wit of man could make everybody better off. Unlike most economists of the 1920s and the 1980s too, Keynes was quite ready to believe that economic and social institutions can easily and frequently yield wasteful outcomes. He would see enormous waste in current rates of unemployment and excess capacity. His fertile mind, his voice, his pen would be busy devising and advocating remedies.

After all, there is enormous waste involved in running economies with idle labour and capital year after year. According to Okun's law, one of the most durable empirical regularities of macro-economics, the percentage of national output lost is a multiple of the excess points of unemployment, a multiple varying from two or three in western economies to twenty-five in Japan. Okun's law was not known to Keynes, but he would have liked it. Shortly after publication of *The General Theory*, researches of Dunlop, Tarshis, and Ruggles challenged Keynes's unquestioning acquiescence in the 'classical' assumption that output is less cyclically variable than employment. Keynes saw immediately that their results strengthened his case.

Today, of course, unemployment is much less a source of individual hardships than it was fifty years ago, thanks to the welfare-state beneficences of our more affluent societies. But, contrary to all too common belief, the social cost of unemployment in lost output is no less because its burdens are shared by the whole society. As Keynes would surely observe, it is hard to see what is being gained by the current wastes of under-utilization, or how they are ever supposed to end.

Money, wages, prices, and unemployment in Keynesian theory

Parallel to the public debates on current economic developments and policies, a theoretical controversy rages within the economics profession. For Keynes that controversy would be *déjà vu*. The issues are the same ones that engaged him fifty to sixty

years ago: the existence, strength, and speed of self-adjusting mechanisms that would return a decentralized capitalist economy to full employment equilibrium, and the necessity and desirability of active policies of demand management. Hardly anyone would contend that any major western economy is now at its full employment equilibrium; even the United States, whose recovery from the 1980-2 slump has surpassed Europe and Japan, still has unemployment at least a full percentage point above reasonable estimates of its 'natural rate'. Will the automatic recuperative powers of these economies suffice to bring complete recovery, in the absence of any active assistance from monetary and fiscal policies? In particular, will measures dedicated to continued disinflation, even to deflation, create jobs for the unemployed? These questions are *déjà vu* for me too. My first professional work and publication concerned the Keynesian answers. I am going to remind you of them now.

Everyone remembers, every student is taught, that Keynes believed *money* wage rates to be, if not rigid, sticky. To this institutional fact of modern industry he attributed the appearance of 'involuntary' unemployment in response to downward shocks to aggregate demand. Likewise, an increase in aggregate demand could increase employment, if necessary by raising prices and profit margins, lowering real wage rates. For a long time Keynesian economics has encountered intellectual resistance in the profession for lack of a theory of rational choice and expectations that would explain this alleged stickiness of money wage rates, or more generally and more realistically the inertia in trend paths of money wages. In the last decade this resistance erupted into a full-blown counter-revolution. Empirically, moreover, experience in the more inflationary weather of recent decades has increased indexation of wages, formal or informal, and raised the likelihood that rigidity or stickiness applies more to real than to nominal wage rates. Keynes quite explicitly agreed that the ball game would be quite different if labour-management bargains set real wages. In that ball game, a strategy of waiting for unemployment to drive money wages down relative to fixed paths of money supply and to prices might make sense, whereas 'Keynesian' demand stimulus would keep real wages too high for re-employment while ratcheting up prices and nominal wages.

Keynes's assertion of money wage stickiness has aroused the suspicions of theorists because it has been interpreted, even by sympathetic expositors, as an *ad hoc* attribution of irrational 'money illusion' to wage-earners. I bear some guilt in this matter

myself. But I now think, as I said at the celebration of the master's rooth birthday at Cambridge two years ago, that this interpretation does Keynes an injustice.

Keynes provides, or at least almost provides, a theory free of the taint of irrationality. The level, or path, of nominal wages and prices does make a real difference in the short run; but the departure from neutrality or homogeneity is not vulgar 'money illusion'. Rather it is a consequence of the institutional fact that wages and prices are set or agreed in *decentralized* markets, negotiations, and decisions in *the monetary unit of account*. But it requires two other assumptions.

The first of these is very explicit in *The General Theory*. It is that workers are primarily concerned with *relative wages*. Therefore, an economy-wide increase in prices, which at prevailing money wages lowers all real wages proportionately, is more acceptable to any group of workers than a local reduction in its money wage, which is perceived as damaging the group's relative position. Students of labour relations know that Keynes was right to stress the crucial importance of relative wages. This argument is perfectly clear in *The General Theory*. Consumer or worker interdependence, in the sense that A's utility function includes as arguments the quantities consumed by B, C, . . . Z, violates no canon of rationality. It is ignored in favour of purely individualistic specifications by Invisible Hand theorists because it is an annoying and possibly damaging complication.

The argument is not complete without a second auxiliary assumption, which is not at all clearly stated in Keynes. Although his informal language refers to collective bargaining, he pretends that he is always talking about purely competitive auction markets for labour as well as for other commodities. But in such markets there is no explanation why unemployed workers would not prefer jobs at lower wages—relative and absolute, real and money—to idleness, or why employers would not hire them or threaten to hire them to replace any relative-wage-conscious employees. That the insiders actually do have considerable power to prevent such replacement or to make it costly to the employer is a realistic fact, but it is understandable only in a framework of imperfect competition. Lord Kaldor, Professors Iwai, Weitzman, Hahn, and Solow, and many others have stressed this point and have been busy trying to describe the imperfect competition micro-foundations of Keynesian macro-economics. I shall not enter that terrain in this lecture.

Most people forget, most students never learn, the second of

the two prongs of Keynes's argument regarding the nexus of wages and employment. Keynes was very sceptical of the efficacy of wage deflation—we could with more generality say disinflation—in eliminating involuntary unemployment. He appealed to a quintessential neo-classical argument, the neutrality of aggregate real demand for goods and services, and therefore for labour, with respect to nominal variables. Should not real quantities demanded be the same, and should not real wages and other relative prices come out the same, at one level of nominal prices as at another? Keynes made fun of the fallacy of composition, the neglect of aggregation, involved in applying Marshallian partial equilibrium methods, demand and supply curves, to analysis of the effects of a money wage cut as if the demand schedule were independent of the outcome. In a general equilibrium setting, he argued, there was no assurance that reduction in the money wage would eliminate excess supply.

The general verdict in the history of macro-economic thought is that Keynes lost this theoretical argument. His initial presentation of the point in Book I of *The General Theory* assumed his 'liquidity trap', a special case of possible relevance to the Great Depression, in which nominal interest rates were at irreducible floors set by the zero yield of currency. Two hundred pages later in Chapter 19, he recognized that otherwise a general lowering of nominal prices and wages would increase the purchasing power of a given nominal quantity of money, lower interest rates, and raise aggregate real demand. In the parlance of subsequent textbooks, this came to be known as the 'Keynes effect'. Keynes did observe that the same expansion of the real money stock could be more easily achieved by enlarging its nominal quantity; he saw no reason why anyone would prefer to wait for or to engineer the socially disruptive process of money wage cutting.

Keynes's personal friend and intellectual foil, his prototypical 'classical' economist, Professor A. C. Pigou, was not content to admit even the liquidity-trap exception to the general principle that price adjustments can eliminate excess demands or supplies. The 'Pigou effect'—the effect of increased real wealth in net nominal assets on consumption and other real demands—would always work in the equilibrating direction. Pigou's purpose, it should be remembered, was not to oppose common-sense demand creation as antidote to Depression. Rather, he was concerned to defend the pure logic of static neo-classical theory, against Keynes's claim to have found a legitimate new *equilibrium* with permanent excess supply.

In that abstract sense Pigou did win the argument—one in which Keynes himself, because of illness and wartime preoccupations, never participated. Wassily Leontief observed that if prices were low enough he could buy the whole Gross National Product with one thin dime. But the abstract victory has little operational significance—much less, I think, than is credited to it by many neo-classical theorists. There are several reasons for doubting the practical importance of the Pigou effect.

First, the base to which it applies is small relative to GNP. Total federal debt in the United States, for example, is 40 per cent of a year's GNP; the non-interest-bearing monetary component is only 6 per cent of GNP. According to an old argument recently revived by Robert Barro, at least part of the interest-bearing debt corresponds to future liabilities foreseen and internalized by some taxpayers. The marginal propensity to spend from unanticipated increases of real wealth is estimated to be about 0.05. Thus a 10 per cent general reduction of prices would increase net private wealth by something between six-tenths of 1 per cent of GNP and 4 per cent, and increase real aggregate demand by something between three-hundredths and two-tenths of 1 per cent.

Second, these miniscule effects can easily be swamped by disaggregated responses ignored when gross private assets and debts are netted out. As Keynes himself pointed out, and as my great predecessor at Yale, Irving Fisher, vigorously argued throughout the Depression, the effects of general price reductions on debtors are devastating, especially when the borrowers did not anticipate them. The restrictions of the debtors' spending are very likely much greater than the stimulus of the corresponding real capital gains on the creditors' spending. The failure of asset and debt effects to wash out, even though the assets and debts wash out in aggregation, could easily reverse the sign of any real balance effect short of Leontief's extreme thought experiment. The contractionary effects of deflation or disinflation via the burden of nominal debt are other old lessons we are relearning in the 1980s—in Iowa and Minnesota as well as Brazil and Mexico.

The third point is probably even more crucial; it undermines the Keynes effect as well as the Pigou effect. It has to do with dynamics and expectations, and for that reason it was excluded by the rules of the neo-classical comparative statics game from Pigou's abstract rebuttal to Keynes. The Keynes and Pigou effects both compare alternative price *levels*, without considering the process of moving from a higher to a lower level. During that process, prices and money wages are falling; presumably they

are expected to be falling, possibly in advance because of announcements of disinflationary policies, and surely after the process has begun. As Keynes observed in Chapter 19, a thorough pragmatic catalogue of the channels from deflation to aggregate demand, deflationary expectations are equivalent to increases in interest rates. They deter aggregate demand. The level change may be equilibrating, but the process of making it is disequilibrating. Any mechanism of adjustment with effects so ambiguous is suspect. This is why Keynes, unlike most of us today, regarded the stickiness of money wages as a desirable stabilizing anchor to the system rather than a source of trouble. In this view, as in few others, Schumpeter concurred.

Incidentally, the perverse effects of the expectations generated by equilibrating movement of the price level is dramatized by returning to the liquidity trap and observing that inflation, not deflation, would be the means to prosperity, lowering real interest rates and promoting investment. Keynes did not discuss this possibility. On the American side of the ocean, Irving Fisher did advocate 'reflation' of prices as a central part of his strategy. And indeed it was a central part of President Roosevelt's strategy in his first term, 1933-6, rationalizing both his boost in the price of gold and some unfortunate micro-economic measures to raise prices.

In 1975 I tried to combine the static and dynamic effects of price changes in two simple models, both of which had the same full employment or 'natural rate' equilibrium. In both models inflation expectations adapted to deviations of actual inflation from past expectation. In the 'Keynesian' model, output moved in response to deviations of aggregate demand from existing output; prices moved according to an accelerationist Phillips curve in response to deviations of actual output from full employment output. In the 'Marshallian' model, these adjustment equations were reversed: prices responded to the first deviation, output to the second. In the terminology, indeed in the whole enterprise, I was inspired, of course, by Milton Friedman. He had pointed out how Keynes, though a Marshallian in training and method, had in the process of translating the demand-supply framework of Marshall from individual markets to the whole economy, reversed the adjustment roles assigned to prices and quantities, making quantity the variable that moves relatively rapidly. Some of you will recall that in Marshall quantity adjusts to difference between demand price and supply price at existing quantity, while in Walras—and in Keynes—quantities adjust to difference between demand quantity and supply quantity at existing price. Anyway,

it was easy to show that the Marshallian model is stable, while the Keynesian model is very likely unstable locally; even if locally stable it could be unstable for large departures from equilibrium.

While I still believe an argument of that kind is instructive, I know that it is subject to the rational expectations critique. According to that critique, economic agents will understand the model's comparative statics, will know what the new equilibrium price level is, and will cause prices and wages to *jump* in zero real time to the new equilibrium or possibly to a singular path along which correct expectations will steer the system to the new equilibrium. In the latter case agents will dismiss as irrelevant the many divergent paths along which expectations would be self-fulfilling, because in infinite time they transgress feasible bounds. I am not persuaded. How do the agents in practice know how far a price level must fall to restore equilibrium? How do they come to agree among themselves about the destination? Given that prices are decision variables by individual agents, changed at different intervals in differing amounts, how is the required jump to occur in zero time? I think there is plenty of evidence that processes of inflation, disinflation, and deflation, generate destabilizing expectations. A successful stabilizing disinflation or deflation probably requires central guidance to focus the expectations of diverse agents on a common target within the capabilities of the authorities to achieve. Even that may not suffice.

Recent experience confirms the empirical generalization that deflationary, or disinflationary, times are hard times. This was true in the recessions following the two oil shocks of 1973-4 and 1979-80. The second case is the more interesting and significant. There was no mystery about the intentions of the monetary authorities of all the major economies of western Europe, North America, and Japan. Both their words and their actions five years earlier made it clear that they would resolutely tighten to bring down inflation. The new classical macro-economists told us that when workers, unions, employers, and other agents understood the new policy regime, disinflation would be much less costly and much more rapid than in the bad old days when they could expect government to save their jobs and markets whether or not they disinflated. The result has been the worst and longest slump since the Second World War.

Effective demand as macro-economic constraint

Keynes's theory of *effective demand* was in an important sense the central theoretical contribution of his book. He saw that the

demands for commodities and for labour that actually appear in markets are generally not those described in Walrasian general equilibrium equations, which depend solely on prevailing relative prices and on exogenous 'endowments' of real resources. Market demands are constrained by the actual sales of those resources, which may be smaller than the desired exchanges described in those equations. This common-sense observation is the reason Keynes appropriated the word 'general' for his theory; neo-classical equilibrium is the special case where endowments, not market sales, are the binding constraints on demands. Multiplier theory, as in Kahn's famous seminal article and in Keynes, was the principal immediate application of the principle of effective demand. But it is by no means the only implication. The principle applies to intertemporal systems as well as to one-period models. It is not confined to literal liquidity constraints. Worker-consumers need not be constrained in their current purchases by their current cash incomes. Their consumption and saving today, and their plans for tomorrow, will nevertheless be shaped by involuntary unemployment whether in the current period or expected with some probability in future periods.

The principle of effective demand has been rediscovered, elaborated, and formulated with mathematical rigour by a number of theorists in the last twenty years, under the rubric 'disequilibrium theory'. I refer to the work of Barro and Grossman in the United States, and to that of Malinvaud, Grandmont, Benassy, and their colleagues in France. 'Disequilibrium' is created by the freezing, arbitrary and unexplained, of prices and wages at values other than those of Walrasian general equilibrium. Quantities must then adjust—as in simplest multiplier models—to determine market outcomes. The analyses are rigorous and elaborate, but their impact has been limited by the perception that they gratuitously leave out the equilibration provided by adjustments of relative and absolute prices and wages. In this respect, they seem even more vulnerable to the charge of being *ad hoc* than Keynesian wage and employment theory itself. But the burden of the previous section of my lecture is that Keynes thought, and with considerable justice, that the principle of effective demand applies even to situations in which prices and wages are not frozen. Thus it is a constraint on real outcomes over a much wider set of assumptions about price flexibility than those entertained by the 'disequilibrium' theorists.

In this context too Keynes's desire to play and win on his opponents' home field and with their rules of the game was a

handicap to understanding and acceptance of his theories within the profession. How are macro-economic demand constraints felt by individual firms, who in purely competitive theory are supposed to adjust only to price signals? Imperfect or monopolistic competition theory can help. Business managers for whom prices are decision variables feel variations of quantities demanded of their products quite directly. They are sceptical of how much additional demand they can induce by price-cutting. Though they may feel forced to cut to hold customers, they do not think that competition with their rivals is going to gain much more business for the group as a whole. Thus much of their adjustment to demand shocks, economy-wide or local or some ambiguous mixture of the two, will be in quantities rather than prices, especially in the short run.

Obstacles, imaginary and real, to demand stimulus

I have given Keynesian reasons for scepticism that waiting passively for deflation will restore prosperity any time soon. The implication is that active stimulus, from monetary or fiscal policy or both, would be necessary. But maybe such stimulus would not be sufficient. Maybe demand stimulus would not raise output but only raise prices and inflation rates. Maybe it would raise output and employment, but only at unacceptable inflationary cost. Those fears are orthodox doctrine on this side of the Atlantic, both here in Britain and across the Channel. There are several reasons.

One general reason for rejection of demand stimulus as the means to recovery is the history of the last twenty years. Cyclical expansions peaking in 1969, 1974, and 1979 ended in price accelerations followed by recessions. These events are blamed on expansionary policies, mostly in the United States; governments are resolved not to repeat those mistakes. The common view is that countercyclical demand management, derided as 'fine-tuning', so far from successfully stabilizing economic activity, has been the principal source of instability. From this version of macro-economic history, Vietnam, OPEC, and the Iranian revolution are conspicuously missing. Memories are short. Those external shocks were in fact major factors in the disappointing inflationary and stagflationary experiences of the late 1960s and the 1970s. Prosperity in the 1980s should not be sacrificed to a costly misreading of history.

After all, recovery in the United States since November 1982 seems to show that monetary and fiscal stimulus both work and

that the recovery they bring about has very little inflationary by-product. The Federal Reserve, under Paul Volcker, reversed course in August–October 1982 and turned the economy around. The Fed has been fine-tuning the recovery ever since. The federal budget began about the same time to deliver a super-Keynesian boost to demand. Never mind that Reagan budgets were advertised as anti-Keynesian supply-side programmes—the big tax cuts worked because they were spent, and defence spending more than offset Stockman's cuts in civilian programmes. Since it was mainly American experience that, probably unjustifiably, gave Keynesian demand management a bad name, the most recent evidence seems to be relevant. But now, it turns out, the United States is alleged to be uniquely situated to benefit from macro-economic measures that would be disastrous elsewhere.

Unemployment in Europe, unlike America, is diagnosed as classical, attributable to rigidity of real wages: that is, expansion of employment requires increases of profit margins. Otherwise expansion of demand will simply raise both prices and nominal wage rates. One version of this argument is that the real wage trend has never adjusted to the energy and productivity shocks of the 1970s. Yet profit margins have improved, and productivity growth has picked up. Expansion will not require downward adjustment of real wages if businesses already enjoy large enough profit margins to allow them to respond to increased demand. Moreover, in the absence of formal indexation any necessary downward adjustments may occur automatically.

In any event European governments and central banks seem as ever quite willing to let their economies respond to externally generated demand, specifically the double-barrelled increase due to the expansion of economic activity in North America combined with the appreciation of the dollar. It is not clear why demand expansion from this source, indirectly due to Keynesian policies, should be less hazardous and more tolerable than domestic stimulus. European governments may rule out expansionary monetary policies because of the internal price effects of further depreciation of their currencies. Fiscal stimulus to demand is what the doctor prescribes in these circumstances. Recessions are not the time for budget-balancing austerities.

A 'supply-side' diagnosis of the 1970s' stagflation is that the burdens of government taxation, expenditure, and regulation drained our economies of enterprise, vitality, and flexibility. Like the reading of history that blames Keynesian macro-policies, this diagnosis ignores the unique external shocks of the decade and

forgets how the world economy prospered and grew in previous decades despite those same burdens.

Nevertheless, welfare-state benefits available to the unemployed could well be a source of the wage rigidities and immobilities that impede adjustment and recovery. This is an empirical question, to which the answer doubtless varies from country to country. Strangely enough, welfare-state reforms and economies seem to be a bigger issue in the United States, where they are least needed. Americans of all colours of the political spectrum are always amazed to learn how much more generous, universal, and open-ended are the benefits available to unemployed, never employed, students, parents, disabled, working poor, and senior citizens in many European countries. After hearing our President tell us daily how the government he heads is Leviathan, we are astonished by the statistics that show us to have one of the smallest public sectors of advanced capitalist democracies. We could lend-lease David Stockman; it might be Pareto-optimal.

Tempted as a foreign observer is by the sheer magnitudes of European unemployment rates to believe that Europe has a bad case of macro-hypochondria, I suppose an outsider cannot dismiss out of hand the reality of the various ailments complained of. I find it difficult to see good reasons against expansionary demand policy in Germany, the key country of the European Community.

Britain, in contrast, may be the prime example of a society that has contrived to place itself in an impasse from which there is no escape by macro-economic management. That is, there is no remedy for high unemployment that does not carry substantial risk of high inflation. Or worse, there is no remedy for high inflation, not even high unemployment. If the distribution of political and economic power in the society is such that no viable and durable consensus exists either on the division of the pie or on the mechanism by which the pie should be divided, there is no reason to expect that making the pie smaller will solve the problem. If this is the case, inflation is just a symptom of a deeper and more disturbing conflict than either free markets or finance ministries and central banks can resolve.

Keynes did not believe that aggregative demand management policies alone could always stabilize economies at full employment. He commonly regarded the level and trend of money wages as a matter of public policy, something that could not be left to managements and unions by themselves. For example, after

Churchill, as Chancellor of the Exchequer, returned sterling to its ancient parity with gold and the dollar, against Keynes's advice, Keynes urged the government to take an active role of leadership to put British wages down the 10 per cent he estimated to be the over-valuation. Surely today he would see that the tendency of wages to rise prematurely, inflating prices at the same time, is the major barrier to full employment. He would not rest until he found a solution and persuaded the country to adopt it.

Several kinds of solution have been proposed, in this country and elsewhere: wage and price guideposts, tax-based incomes policies, social contracts, legislation designed to limit trade union powers and to make union leaders more responsive to the interests of the unemployed, tax incentives for the adoption of profit-sharing systems. Something must be done. The stakes are high, and the problem will not solve itself.

Financial market 'confidence' as constraint on macro-economic policy

Keynes emphasized very strongly the importance of expectations in determining the course of economic events. Moreover, he thought that the decisive expectations concerned future events about which rational probabilistic calculus was almost impossible. Thus psychological mood, arbitrary and perhaps volatile, subject to contagious fashions of opinion, would generate fluctuations in investment and in aggregate effective demand. In this connection he used the famous and often repeated phrase, 'animal spirits', the subject of Professor Robin Matthews's Keynes Lecture last year.

Although swings of expectation and psychology give the government the opportunity and the responsibility to stabilize the economy, Keynes did not think this was an easy task. Mechanical versions of fiscal policy using multiplier arithmetic and of monetary policy using Hicksian 'IS/LM' apparatus give students a misleadingly simple view of macro-economic policy. Keynes was quite aware that the effectiveness of such policies could be undermined by distrust or misunderstanding of them, or reinforced by confidence in policies and in the governments administering them.

Business managers and capitalists are influenced by the economic theories and models they believe, perhaps—as Keynes said—those of unknown defunct academic scribblers. They are influenced by ideology and political partisanship. If they distrust deficit spending and fear its long-run effects, their reluctance to invest may reduce its effective multiplier. Of course, their minds may change as actual orders for their products materialize and

coins clink over the counter into their cash registers. The American business and financial establishment has accepted, and responded to, super-Keynesian budget policies under a President, Ronald Reagan, they liked; the same budgets would have appalled them under Jimmy Carter or Kennedy.

The trick is to develop policies in which decisive economic agents have confidence, and to generate confidence in policies which will work. Both are necessary; I guess that is a 'rational expectations' point. It does no good to follow policies that command enthusiastic support if those policies will not in fact deliver the results that attract the enthusiasm. The extravagant promises of supply-side economics in the United States can never be realized even if people now believe them. On the other hand, it may do no good to propose and follow policies that would work as advertised only if people were so persuaded, unless they are in fact persuaded by the advertisements.

In America in the 1960s it seemed for a fleeting moment we had converged on a winning combination. After initial scepticism the Establishments had accepted what was then called, albeit inaccurately, the 'new economics', an eclectic blend of Keynesian and neo-classical ideas and policies. Their confidence made stabilization policies more effective. Unfortunately the convergence of attitude, confidence, and policy evaporated under the shocks of Vietnam, Watergate, and OPEC, and a new consensus has yet to emerge.

In Keynes's world, the Great Depression, beliefs in financial markets that real interest rates would rise once again to prosperity levels kept long-term rates higher than short rates. Those long-term rates affected stock prices, kept market valuations of capital below replacement cost, and deterred real investment. Business managers, however, did not expect a rise in earnings on capital commensurate with financial investors' expectations of higher interest rates. This asymmetry in the views of savers and investors—one of the several reasons Keynes emphasized the differences between the agents on the two sides of capital markets—created the impasse Keynes described in his remarks on liquidity preference. Depression-bound expectations of returns on real capital were being evaluated at prosperity-level long-term interest rates.

Though the world economy is stagnant today, we are far from Keynes's liquidity trap. But a similar asymmetry is a troublesome obstacle to expansionary policy. It too produces a premium of long-term interest rates above short rates. Savers, via the

insurance companies, pension funds, and other intermediaries who manage their portfolios, are worried about future inflation. They may be worried about the accumulation of public debt and about possible future 'solutions'—monetization or crowding-out. Investors, business managers, do not have corresponding expectations of either prosperity or inflation. For them, the interest rate premium is real, and they do not see the higher earnings that would justify it.

In some countries, savers and investors are, or are thought to be, skittish about expansionary macro-economic policies, monetary or fiscal, in such degree that such policies would be defeated by a rise in the premium of long rates over short. Worse yet, business expectations that such policies would be inflationary in the short run but, via later policy response, recessionary thereafter, make them sceptical of the earnings from present capital investments. Stories of this kind are sometimes fictional, even though they are accepted as gospel. In 1982 the Federal Reserve was thought to be, and for a long time thought itself to be, prisoner of its own monetary targets. Those targets were choking the economy to an unintended degree, but the Fed's anti-inflationary credibility was thought to depend on adherence to them. The accepted scenario was that faster monetary growth would so scare lenders in the financial markets that interest rates would shoot up. When Paul Volcker and company nevertheless suspended the restrictive monetary targets and came to the rescue of the world economy, interest rates, both long and short, actually fell. Everybody but the most religious monetarists breathed a huge sigh of relief.

There are some uglier aspects of these problems, involving not just ideologies and theories of macro-economics but also issues regarding the distribution of economic power and wealth. Governments, like President Reagan's, that follow conservative policies regarding taxation, redistribution, regulation, and the size of the public sector have evidently greater licence in macro-economic fiscal and monetary affairs than liberal or social democratic regimes. Government expenditure for defence is less disturbing of confidence than welfare transfers and civilian projects.

I am tempted to speculate that European conservative governments are not following policies that will justify the confidence their policies have in establishment circles. Their macro-economic policies are certainly 'sound'. They eschew countercyclical demand management, disavow targets for unemployment or other real variables, give first priority to price stability, avoid

social contracts and other incomes policies, seek to balance budgets even with revenues depressed by under-performing economies, rely on automatic adjustments via flexible wages and prices to restore employment and growth. This policy stance will work, if at all, only with micro-economic institutions that ruthlessly promote flexibility of wages and prices, competition, and mobility. But the governments do not have the political will or clout to destroy the social institutions and welfare-state programmes on which they themselves blame the slowness of adjustment and recovery.

The General Theory argued that there are macro-economic equilibria other than the 'classical' full employment solution. The stagnation of the 1980s may be confirming that intuition, though not precisely in the manner Keynes envisaged. These days we could think of an equilibrium as a state of *political* economy that tends to perpetuate itself. Under-employment persists for several reasons. The forces of automatic adjustment via disinflation resulting from economic slack are too weak to restore prosperity. Active demand stimulus is doctrinally out of bounds even in countries where it has a good chance to work. Elsewhere the way appears to be blocked by inflation-prone institutions. There is no natural consensus for co-operative reform of these institutions, and governments do not muster the will or power to impose a solution. Unemployment insurance and other subventions keep the jobless from open mutiny, and the more fortunate majority forgets them.

Keynes would be trying to spring us from this low-level trap.