What Goes Around, Comes Around: Fluctuations in the popularity of Keynesian economics

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Public Lecture, Thursday, 3 August 2017, at 18:45 in the Alumni Theatre, New Academic Building.
INTRODUCTION:
As the title of the current Public Exhibition is “A Wealth of Ideas: Economics and LSE”, I have chosen to begin my talk with a controversy that developed between LSE and Cambridge in the 1930s. The first part of the title (What Goes Around, Comes Around) was chosen as the examples I will discuss illustrate a feature of economics as a subject, namely that unlike the physical sciences, ideas in economics may fade away, but they seldom disappear entirely.

CAMBRIDGE – LSE – VIENNA:
The three important people at the outset are John Maynard Keynes in Cambridge, Lionel Robbins at LSE and Friedrich Hayek at the University of Vienna. What was happening to the subject of economics in these three institutions in the period before our story opens?

**Cambridge:** Here economics was dominated by Alfred Marshall, whose *Principles of Economics* (1890) was treated like a bible (“It’s all in Marshall”). Otherwise, economists not interested in developments elsewhere, particularly in Europe.

John Maynard Keynes (1883 -1946) studied Mathematics initially, but then was a pupil of Marshall after switching to economics. He was unusual, as instead of staying on at Cambridge to wait to become a college fellow and settle into a comfortable academic life, he left Cambridge in 1905, took the Civil Service Examination and a post in the India Office. He returned to Cambridge to a fellowship at King’s College in 1909, but retained his interest in public activities. He was on a Royal Commission on Indian Currency and Finance in 1913 and was involved as an independent advisor to the Treasury during World War 1. In January 1919, he was part of the British delegation at the Versailles Peace Conference, but was so disgusted by the Allied plans to punish Germany economically that he resigned and returned to Cambridge, where he wrote *The Economic Consequences of the Peace* (1919).

**LSE:** Economic theory was here taught by Edwin Cannan (1861-1935) from 1895 to 1926. He studied at Oxford and was independent of Marshall, but he taught Marshall’s *Principles*, although was highly critical (“Here, poor old Marshall got it wrong again”). His philosophy was liberal and he advocated free markets and free trade.

One of his students was Lionel Robbins (1898-1984). The B.Sc. (Econ.) degree had language requirements and Robbins enjoyed reading economics in German, which led him to an interest in the work of Austrian economists in Vienna. In 1929 Robbins returned to LSE from a fellowship at College, Oxford to become the youngest professor of economics in the UK. He was keen to persuade Friedrich von Hayek (1899-1992), an Austrian economist, to visit LSE.

**Vienna and Austrian Economics:** Carl Menger’s *Principles of Economics* (1871) is usually cited as the starting point for this view of economic theory. The details are not important for this talk, except for two of the underlying assumptions. For example, in 1981, Fritz Machlup, a leading Austrian economist, listed the typical views of Austrian economic thinking (Machlup 1981, 2004). The first two of six items were:

- **Methodological Individualism:** In the explanation of economic phenomena, we have to go back to the actions (or inaction) of individuals; *groups or "collectives" cannot act except through the actions of individual members.*
- **Methodological Subjectivism:** In the explanation of economic phenomena, we *have to go back to judgments and choices made by individuals* on the basis of whatever knowledge they have or believe to have and whatever expectations they entertain regarding external developments and especially the perceived consequences of their own intended actions. [**Bolding NOT in the original.**]

This emphasis on the role of individuals and not groups or collectives is important, as we shall see below.

Friedrich von Hayek (1899-1992) fought in the Austrian army in World War 1 before enrolling in the University of Vienna, where he obtained doctorates in Law in 1921 and Political Science in 1923. He was
influenced by the work of Carl Menger and other members of the Austrian School. He spent time at New York University in 1923-24 and became the Director of the Austrian Institute for Business Cycle Research in the late 1920s. In 1931 Hayek was invited to LSE to give some public lectures. These so impressed those at LSE that Hayek was appointed as Tooke Professor of Economic Science and Statistics.

BACKGROUND: Initially, all three economists believed in individual liberty, in free markets and free trade, and in the ability of the system to self-right itself over the peaks and troughs of the business cycle. Government was not to interfere with this process as it would get in the way of the adjustment process in the markets. However, Keynes began to worry about whether the free trade, free market system could adjust fast enough to prevent mass unemployment, with stagnant income and trade threatening this individual freedom. In his political journalism, he argued for government intervention with public works programmes, while in his theoretical work he explored the possibility that under certain conditions the economy might get stuck and not return to full-employment equilibrium. This combination of political journalism and theoretical deviation was seen as a danger by Robbins and Hayek.

ROUND ONE: In 1930, Keynes published *A Treatise on Money* and Robbins asked Hayek to review it for *Economica*, the LSE house journal. His critique was divided into two parts, to be published in August 1931 and February 1932, in the hope that Keynes would respond by February. Keynes did so, but quickly moved from discussing Hayek’s criticisms to an attack on Hayek’s recently published book *Prices and Production*, expressing a low opinion of its merits:

> The reader will perceive that I have been drifting into a review of Dr. Hayek’s *Prices and Production*. And this being so, I should like, if the Editor will allow me, to consider this book a little further. The book, as it stands, seems to me to be one of the most frightful muddles I have ever read, with scarcely a sound proposition in it beginning with page 45, and yet it remains a book of some interest, which is likely to leave its mark on the mind of the reader. It is an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam. (Keynes, 1931, p. 394)

Keynes ignored the second part of Hayek’s review, but the attack on Hayek’s work continued and the March 1932 issue of the *Economic Journal* contained a critical review by Pietro Sraffa of Hayek’s book *Prices and Production* to which Hayek had to respond.

So, at the end of Round One, Keynes had not been affected by Hayek’s criticisms and Hayek himself was under attack from Cambridge. Keynes moved on.

ROUND TWO: In 1936 Keynes published his *General Theory*, a book that led to the development of macroeconomics, the study of economies through aggregates rather than through the study of individuals and single markets of microeconomics. There was no direct response from LSE to this work, as neither Hayek nor Robbins reviewed it and Arthur Pigou, Marshall’s successor as Professor at Cambridge, who had been savagely criticised by Keynes in the *General Theory* was asked to review it for *Economica*. The impact of the *General Theory* was very powerful and several of the younger LSE economists (e.g. Nicholas Kaldor and Aba Lerner) very soon became converts. So Round Two very clearly went to Cambridge.

WORLD WAR 2: Keynes had suffered extremely poor health from 1938 on, but was involved at the UK Treasury throughout the War. Many LSE staff left for war duties. Robbins worked with Keynes and was semi-converted to Keynesianism, much to the dis-pleasure of Hayek, who explained it on the general principle that ‘all economists who serve in government are corrupted’

LSE moved London to Peterhouse, Cambridge. Hayek and his family had become naturalised British citizens in 1938, so they not interned. Hayek was not wanted for war service, so taught, edited *Economica* and wrote *The Road to Serfdom*, published in 1944. This is not Hayek’s most important work, but his most famous. Very positive response (particularly in the USA) from those who were worried about spread of Communist, but most economists not impressed. However, it led to Hayek making important contacts in the USA.
Hayek’s Case for the Free Market

It was men’s submission to the impersonal forces of the market that in the past has made possible the growth of a civilisation which without this could not have developed; it is by thus submitting that we are every day helping to build something that is greater than anyone of us can fully comprehend. It does not matter whether man in the past did submit from beliefs which some now regard as superstitious: from a religious spirit of humility, or an exaggerated respect for the crude teachings of the early economists. The crucial point is that it is infinitely more difficult rationally to comprehend the necessity of submitting to forces whose operation we cannot follow in detail, than to do so out of the humble awe which religion, of even the respect for the doctrines of economics, did inspire. It may indeed be the case that infinitely more intelligence on the part of everybody would be needed than anybody now possesses, if we were even merely to maintain our present complex civilisation without anybody having to do things of which he does not comprehend the necessity. The refusal to yield to forces which we neither understand nor can recognise as the conscious decisions of an intelligent being is the product of an incomplete and therefore erroneous rationalisation. It is incomplete because it fails to comprehend that the co-ordination of the multifarious individual efforts in a complex society must take account of facts no individual can completely survey. And it fails to see that, unless this complex society is to be destroyed, the only alternative to submission to the impersonal and seemingly irrational forces of the market is submission to an equally uncontrollable and therefore arbitrary power of other men. In his anxiety to escape the irksome restraints which he now feels, man does not realise that the new authoritarian restraints which will have to be deliberately imposed in their stead will be even more painful.

Those who argue that we have to an astounding degree learned to master the forces of nature but are sadly behind in making successful use of the possibilities of social collaboration are quite right in so far as this statement goes. But they are mistaken when they carry the comparison further and argue that we must learn to master the forces of society in the same manner in which we have learnt to master the forces of nature. This is not only the path to totalitarianism, but the path to the destruction of our civilisation and a certain way to block future progress. Those who demand it show by their very demands that they have not yet comprehended the extent to which the mere preservation of what we have achieved so far depends on the co-ordination of individual efforts by impersonal forces.

Hayek, The Road to Serfdom, pp. 151-152. [Bolding NOT in the original.]

POST WORLD WAR 2: Death of Keynes and Keynes versus Keynesian Economics: Keynes died of a heart attack on 22 April 1946, aged 63. In what follows I want to distinguish between criticisms of what Keynes wrote (particularly the General Theory) and Keynesian Economics as developed by others. Given the way Keynes moved on from The Treatise to the General Theory it is likely he would have gone on to develop new ideas. Some of his earlier writings suggested he would have disagreed with parts of Keynesian economics.

Complete domination of Keynesian Economics through to the 1970s. Many economists (particularly the younger ones) accepted the emerging Keynesian Economics. It also affected governments and economic policy.

3 features:

(1) Easy to express as a set of simultaneous equations (e.g. (i) \( Y = C + I \), (ii) \( C = \alpha + \beta Y + u \), (iii) \( I = I^* \), where \( Y \) = National Income, \( C \) = Total Consumption and \( I \) = Total Investment. (ii) is the Consumption Function, with parameters \( \alpha \) and \( \beta \) and \( u \) is a random error. \( I^* \) is exogenous investment).

(2) As part of the war effort Richard Stone and James Meade had developed National Income Accounts, with the economic series collected corresponding to the variables in the macroeconomic models.

(3) Research at the Cowles Commission in the USA provided the statistical theory and computational methods to estimate the parameters in these models. Much econometric model-building activity for forecasting and planning. [In 1939 Keynes had expressed scepticism about econometrics in the Keynes-Tinbergen debate.]

Hayek returned to London and LSE, though now with important links to universities in the USA. In 1947 he founded the Mont Pelerin Society (named after location of the first meeting in Switzerland). It was a gathering of liberal minded economists (Milton Friedman from the University of Chicago was a founding member),
philosophers, historians and other intellectuals, plus politicians and businessmen. The latter important to provide funding for the meetings of the Society, but also to finance setting up think-tanks to carry out research and spread the message. An important example was the establishment of the Institute of Economic Affairs (IEA) in the UK in 1955, following a meeting between Hayek and Antony Fisher (Buxton Chickens) in 1947.

In 1950 Hayek left the UK and headed for the USA for personal reasons. He went to the University of Chicago to a professorship (funded by an outside foundation), not in the Department of Economics (though there were links), but in the Committee on Social Thought. This provided a suitable base for research and he published a number of works, including *The Constitution of Liberty* in 1960, a major study of the importance of the Rule of Law in maintaining personal and economic freedom. This work received little response from the economics profession and this was a depressing time for Hayek.

In 1962 Hayek moved to West Germany to a professorship at the University of Freiburg and, apart from a move to the University of Salzburg between 1969 to 1977, he remained in Freiburg for the rest of his life.

**THE DECLINE OF KEYNESIAN ECONOMICS:**

(1) *Economic Problems:* A major shock to the economies of the US, the UK and many other countries occurred in October 1973, when in response for US support for Israel during the Yom Kipper War, OPEC proclaimed an oil boycott and a sharp increase in the price of oil (from US$3 per barrel to US$12). In attempting to respond to this shock, Keynesian policies seemed to fail and a number of countries (including the US and the UK) experienced low rates of economic growth, high levels of unemployment and high rates of inflation. This combination was described as *stagflation*.

(2) *Theoretical Criticisms:* From early on there were theoretical criticisms of Keynesian economics. Some argued that it lacked microeconomic foundations and it was necessary to go back to the individual and the market to build up a theory of the aggregates. More important were the criticisms of the Monetarist Economists (led by Milton Friedman) who argued that the Keynesians had neglected monetary theory and the importance of inflation. [Monetary theory crucial in Keynes *General Theory of Employment, Interest and Money.*] Others argued that the Keynesians put too much emphasis on Demand and neglected the Supply Side of the Economy.

(3) *Political Changes:* I will concentrate on the UK. The arrival of Margaret Thatcher’s Conservative government in 1979 with a programme to reduce the power of the trade unions, privatise the nationalised industries, remove many economic restrictions and reduce the role of government in the economy. Here there were important links to Hayek.

**HAYEK’S INFLUENCE RESTORED:** For many mainstream economists Hayek arrived with a bang rather than a whimper when he was awarded the Nobel Prize for Economics in 1974, jointly with Gunnar Myrdal “for their pioneering work in the theory of money and economic fluctuations and for their penetrating analysis of the interdependence of economic, social and institutional phenomena”. His Nobel lecture, ‘The Pretence of Knowledge’ ends: “The recognition of the insuperable limits of his knowledge ought indeed to teach the student of society a lesson of humility which should guard him against becoming an accomplice in men’s fatal striving to control society—a striving which makes him not only a tyrant over his fellows, but which may well make him the destroyer of a civilization which no brain has designed but which has grown from the free efforts of millions of individuals.” An echo of *The Road to Serfdom*.

In the UK, Arthur Seldon, the Editorial Advisor at the IEA, had been at LSE in the 1930s and knew Hayek personally from that time. During the late 1960s and 1970s the IEA published a number of pamphlets by Hayek and in 1975 arranged for Margaret Thatcher to meet Hayek at their headquarters. She read his works and, in 1984, recommended him for the Order of the Companions of Honour. He also received many other honours (many political) in the USA and other countries. His position as an original thinker was clearly recognised.

**THE ECONOMIC CRISIS IN 2008:** Fast forward through a long period of politics in which there were policies to remove restrictions on markets and individual institutions. Banks were given greater freedom to develop investment activities alongside high-street banking and this culminated in a financial crisis, when it emerged how much junk (mainly uneconomic mortgages in the USA) had been packaged into Derivatives.
With the banking system needing massive governmental support and risk of a major recession, some politicians introduced financial policies to stimulate the economy and referred to these policies as “a return to Keynesian measures” (Alistair Darling). Initially there was much enthusiasm for this return to Keynesian policies and some economists were converted. Existing Keynesians argued the case for continuing these policies, but the critics of Keynesianism were also active arguing against fiscal stimulation. Over time opinion came around to seeing fiscal stimulation as a short-term measure and, in the US, the swing against Keynes arguments was very strong, with the emergence of the Tea Party. With the arrival of the Cameron Coalition Government in 2010 there was a swing against fiscal policy and to austerity being the main economic target in the UK.

So, while politicians turned to what they called ‘Keynesian’ policies early in the economic crisis, Keynesian economics did return to become the major economic doctrine again. However, it is unlikely to have gone away for good.

CONCLUSIONS: In terms of a crude Keynes versus Hayek confrontation, one would have to concede that Hayek seems to be the winner. In academic terms, Austrian Economics is still going strong and there are more institutions and economic activities associated with Hayek than there are reflecting Keynes’s economics. Politically, Hayek is invoked more often than Keynes.

However, consider the current economic situation in the UK, with slow economic growth and the Bank of England worried about an economy in which economic growth is largely driven by consumption based on high levels of personal debt and the danger of this situation when interest rates finally rise. And then there is Brexit. If one could summon the spirit of either Keynes or Hayek from the great Edgeworth Box in the Sky to advise us on what to do in the current crisis, which of them would you choose?

REFERENCES


