THE KEYNES SOLUTION: THE PATH TO GLOBAL ECONOMIC PROSPERITY VIA A SERIOUS MONETARY THEORY

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For more than three decades, economists, policy makers in government and central bankers and their economic advisors, relying on some variant of classical economic theory, have insisted that (1) government regulations of markets and large government spending policies are the cause of all our economic problems and (2) ending big government and freeing markets, especially financial markets, from government regulatory controls is the solution to our economic problems, domestically and internationally. Since 1980, governments around the world have been freeing up financial markets and claiming to reduce the size of big government.

In 2007-8, global economy experienced a financial market meltdown that led to the Great Recession in which we are still enmeshed even though the NBER proclaimed the recession ended. [Note it is claimed that the Great Depression persisted until World War II even though from 1933 on the US economy showed significant growth except for 1937-1938 when President Roosevelt fearing the growth in the debt to GDP ratio, cut government spending (and the fiscal budget showed a slight surplus) in 1937.]

In testimony before Congress on October 23, 2008 Alan Greenspan said that he had overestimated the ability of free financial markets to self-correct and he had missed the possibility that deregulation could unleash a destructive force on the economy. Greenspan then added “I still do not fully understand why it happened, and obviously to the extent that I figure it happened and why, I shall change my views.”

Greenspan, Bernanke and most economists explain the 2007-2008 collapse of the
investment banks and the shadow banking system to the “mispricing of [probabilistic] risk” despite the fact that many large financial institutions were utilizing some variant of “risk management” models developed by Nobel Prize winning economists (as Greenspan noted in his testimony). This was true even though the Nobel Laureate Scholes’ pricing model [Scholes a Ph.D. from Univ. Of Chicago] did not avoid the collapse of Long Term Capital Management in the late 1990s. The “quants” on Wall Street thought we have to develop better models, i.e., more sophisticated computer models (that no one can understand) to better manage risk!

Keynes’s liquidity theory and the Post Keynesian analysis explains why laissez faire financial markets can not be efficient. The fundamental principles underlying Keynes’s liquidity theory, and his “Keynes Plan” proposal presented at the 1944 Bretton Woods meeting, can explain why free trade, freely flexible exchange rates and free international capital funds mobility are incompatible with the economic goal of global full employment and rapid economic growth. Keynes’s analytical principles suggest policies to alleviate the distress caused by real world experiences as financial market instabilities and bubbles. They also explain why government deficits may be necessary in an economy where aggregate private sector savings out of income are large\(^3\). Also where a system of government unfunded debt liabilities need not lead to financial instability or government defaults. I can not cover all these points in the time allotted, but I hope to point you im the right direction to stimulate you into a further exploration of Keynes’s solution.

As nations deregulated domestic and international markets in recent decades events occurred which would be difficult to justify in most classical economic models. For example (1) the United States continues to run a persist trade deficit since the 1970s, (2) countries that pursued export led growth policies to obtain persistent (mercantilist) favorable trade balances that were
used to accumulate huge foreign reserves are considered to be economic miracles (e.g., Japan in the 1980s, China in the 1990s and 2000s, a even united Germany, etc), at least, until they slip into an apparent persistent recession, and (3) US financial markets that supposedly efficiently allocate capital continually suffered from “bubbles”, e.g., the dot.com bubble of the 1990s and the real estate bubble in 2000s where the latter then spread to create a global banking, financial market and economic crisis, and (4) outsourcing and offshoring created unemployment (and limits if not actually lower) real income for US workers in contrast to the gains that should accrue to labor under the conventional wisdom of the law of comparative advantage.

Some might claim these events are merely short-run exogenous disturbances and in the long run if we maintain our laissez faire faith in free markets, then the economies of all nations will experience global full employment prosperity. Keynes [1936, p. 192] noted that such theorists “offers us the supreme intellectual achievement ... of adopting a hypothetical world remote from experience as though it were the world of experience and then lived in it consistently”.

HOW DO WE KNOW THE FUTURE?

Instant riches await anyone who knows the future of financial market prices! What Greenspan called “risk management intellectual edifice” assumed one merely has to calculate probability distributions regarding future market prices to provide today significant and reliable statistical inferences [information] about the future of financial assets. Financial managers were told to base their decisions on “Risk Management” computer models built by high powered physicists and mathematical statisticians. These complex computer models would permit the decision maker to know with “actuarial certainty” the payoff on any portfolio investment decision made today. These risk management models were based on a scientific methodology which
presumed that probabilities (calculated from past data) can be pooled, managed and tamed to reliably predict the future. Once self-interested decision makers possessed this reliable statistical information about the future, their actions on free markets would optimally allocate capital resources into those activities that will have the highest possible future returns thereby enriching themselves and their stockholders, while assuring global prosperity for all. In such a world, markets are efficient. Instead these computer models turned out to be weapons of math destruction.

Unfortunately as we have all learned in the world of experience, little is known with certainty about future payoffs of investment decisions made today. If the return on economic decisions made today is never known with certainty, then how can managers financial make optimal decisions on where to put their firm’s money and householder’s where to put their saving today?

If theorists invent a world remote from reality and then lived in it consistently, then Keynes [1936, p.16] argued these economic thinkers were “like Euclidean geometers in a non-Euclidean world who discover that apparent parallel lines collide, rebuke these lines for not keeping straight. Yet, in truth there is no remedy except to throw over the axiom of parallels and to work out a non-Euclidean geometry. Something similar is required to-day in economics”.

A theory is more “general” if it has fewer restrictive axioms than an alternative theory. [The dictionary defines an axiom as a “universal truth” that does not have to be proved.] Keynes’s general (non-Euclidean economics) theory rejected three restrictive classical axioms. These were (1) the ergodic axiom, (2) neutrality of money axiom, and (3) the gross substitution axiom.

The Ergodic Axiom. As any statistician will tell you, in order to draw any statistical
(probabilistic risk) inferences regarding the values of any population universe, one should draw and statistically analyze a sample from that universe. Drawing a sample from the future economic universe of financial markets, however, is impossible Simply states the ergodic axiom presumes that the future is already predetermined by an unchanging probability distribution and therefore a sample from the past is equivalent to drawing a sample from the future. [Stationarity is a necessary condition for ergodicity.] Assuming ergodicity permits one to believe one can calculate an actuarial certainty about future events from past data.

Efficient market theorists must implicitly presume decision makers can reliably calculate the future. The economy, therefore, must be governed by an ergodic stochastic process, so that calculating a probability distribution from past statistical data samples is the same as calculating the risks from a sample drawn from the future. If financial markets are governed by the ergodic axiom, then we might ask why do mutual funds that advertise their wonderful past earnings record always note in the advertisement that past performance does not guarantee future results. [For deterministic economic models, the “ordering axiom” which assumes decision makers “know” the future plays the same role as the ergodic axiom in stochastic economic models.]

This ergodic axiom is an essential foundation for all the complex risk management computer models developed by the “quants” on Wall Street. It is also the foundation for econometricians who believe that their econometric models will correctly predict the future GDP, employment, inflation rate, etc. If, however, the economy is governed by a nonergodic stochastic process, then econometric estimates generated from past market data are not reliable estimates that would be obtained if one could draw a sample from the future.

Accepting the ergodic axiom by mainstream economists make a difference in determining
whether there is an active role of government in the economy process or whether everything should be left to the market. Samuelson, Lucas and other mainstream, orthodox economists have adopted, either explicitly or implicitly, the ergodic axiom because they want economics to be in the same class as the “hard sciences” such as astronomy. The science of astronomy is based on the presumption of an ergodic stochastic process that governs the movement of all the heavenly bodies from the moment of the “Big Bang” to the day the universe ends. Accordingly statistical analysis using past measurements of the movements of heavenly bodies permit astronomers to predict future solar eclipses within a few seconds of when they actually occur.

Nothing Congress, the President of the United States, the United Nations, or environmentalists can do will alter the predetermined dates and time for future solar eclipses. For example, Congress cannot pass an enforceable law outlawing solar eclipses in order to provide more sunshine and thereby enhance crop production. In an ergodic world, all future events are already predetermined and beyond change by human action today.

Consequently, if one asserts economics is governed by ergodic stochastic process, then there is no role for government to alter the already predetermined future path of the economy. Government must adopt a laissez-faire philosophy towards economic matters if economics, like astronomy, is an ergodic science. If, however, economics is a nonergodic science, then proper government policies can create-- and thereby alter -- the economic future to improve the human standard of living relative to what would occur under a laissez-faire system of government.

HOW DO WE HANDLE AN UNKNOWN FUTURE?

If in the real world of experience, households, entrepreneurs, portfolio managers, etc., do not have, and can not obtain, any significant statistically reliable information about the economic future, then
they cannot make decisions that will prove, from hindsight, to be efficient. The explanation of market efficiency is the result of accepting the ergodic axiom as the foundation for mainstream economic and financial theory. It is not the fault of using the deductive method, rigor, and mathematics per se. So we should not blame the messenger for the message!

In sum, the ergodic axiom underlying the typical risk management and efficient market models represents, in a Keynes view, a model remote from an economic reality that is truly governed by nonergodic conditions. Keynes, his Post Keynesian followers, and George Soros all reject the assumption that people can know the economic future since it is not predetermined. Instead they assert that people “know” they cannot know the future outcome of crucial economic decisions made today. The future is truly uncertain and not just probabilistic risky. The Keynes liquidity theory and George Soros’s concept of reflexivity reject the ergodic axiom. This alternative view, still provides one with a scientific understanding of the functioning of financial markets in a capitalist system.

For most of the history of mankind, it was believed that the design of God or the Gods was the cause of anything that happened in the world of experience. Beginning in the 17th century, however, some philosophers believed that explanations of events that one observed could be developed on the basis of reasoning of the mind rather than religious belief. This was the beginning of the intellectual movement historians call The Enlightenment or The Age of Reason. The power of reason was not in the possession, but in the acquisition of truth.

Reasoning involves the human mind creating a theory to explain what we observe happening. For example, Sir Isaac Newton saw an apple fall from the bough of a tree to the ground. Newton
explained why apples always fall by the scientific theory of gravity. Charles Darwin created the scientific theory of evolution to explain the different species he observed inhabiting the earth.

In the 21st century, most of society believes that understanding comes with the development of scientific theories. Do we have a scientific theory, or is it the will of God, that explains the change in prices in financial markets?

What is a theory? A theory attempts to explain real world observations on the basis of a logical model that starts with a few axioms. From this axiomatic foundation, the theorist uses the laws of logic to reach conclusions that explains what we observe in the world of experience. All theories are generally accepted in some tentative fashion. Theories are never conclusively established.

The theory’s logical conclusions are presented to the public as the explanation of economic events that are occurring in the world of experience. If the facts of experience conflict with the economic theory, then one or more of the theory’s fundamental axioms are flawed and should be discarded so a different theory can be built. [The alternative would be to change the facts –or even one’s definition of the facts – to fit the unrealistic theory, as, I must admit, sometimes happens in academia and in Washington.]

Furthermore we must recognize that the aim of science is to understand processes that are occurring in the external world around us. Prediction about future events may be a tool of certain scientific methodology but it is not the goal of science itself. Nor can all scientific theories provide the basis for making accurate predictions. At best prediction may be regarded as a useful by product if it can be attained under the theory developed.
The basic classical Ricardian-type model is of an economic system where people know with certainty the future. In more modern dress, mainstream classical theory assumes decision makers possess rational expectations which provide actuarial knowledge of the future. People make “real” decision and are not “fooled” by nominal values in their business and consumption decisions, i.e., a fundamental classical axiom is that money is neutral. [see Lucas (1972)]. But if money is neutral, should financial market crashes in nominal terms (as the global economy experienced in 2007-8) have any effect on the real economy? After all, the marginal physical productivity of the underlying real capital assets are unchanged and therefore their real productivity value should be unchanged.

In their book entitled General Competitive Equilibrium, Arrow and Hahn (1971, pp 256-7 emphasis added) wrote

"The terms in which contracts are made matter. In particular, if money is the goods in terms of which contracts are made, then the prices of goods in terms of money are of special significance. This is not the case if we consider an economy without a past or future. . . . if a serious monetary theory comes to be written, the fact that contracts are made in terms of money will be of considerable importance“.

Thus intelligent general equilibrium classical economists such as Arrow and Hahn can not help but let their common sense intervene in their view of the economy – to the detriment of their logical consistency with their general equilibrium (Arrow-Debreu) model.

Keynes’s liquidity theory provides a “serious monetary theory” for domestic and international transactions because it emphasizes the use money contracts as a way of coping with an uncertain future. Keynes provided a new way of economic thinking which explains the
operations of a monetary economy where entrepreneurs and households enter into money denominated contracts in order to organize market oriented production and exchange activities.

In the world of experience, decision makers know that they do not, and can not, know the future. Accordingly, the capitalist system has (1) developed this institution of legal money contracts that are used in all market-oriented production and consumption decisions to provide decision makers, operating in an uncertain world, with some legal certainty about future cash inflow and outflow outcomes of today’s decisions and (2) the liquidity concept which is the ability to meet one’s money contractual obligations as they come due. This liquidity concept is an essential aspect of decision making in a capitalist economy and a financial markets system.

The sanctity of money contracts is the essence of the capitalist system and Keynes’s analysis and that is why Keynes’s theory is, in the Arrow-Hahn terminology, a serious monetary theory. In the Keynes-Post Keynesian theory, liquidity, i.e., the ability to meet one’s money contractual commitments domestically and internationally becomes an essential foundation for understanding decision making in the operation of an entrepreneurial economy.

Under the civil law of contracts money is that thing that a government decides will settle all legal contractual obligations. And since the government makes and enforces the legal system, for all law abiding citizens, this need for liquidity typically takes the form of making sure that each person or enterprise maintains a positive balance in their checkbook over time so that all contractual obligations can be met as they come due. If, at any time, one’s bank deposit is close to being overdrawn, the typical solution you and I engage in is either:

(1) stop making more contractual payment obligations until more of one’s cash inflow is increases one’s deposit into one’s bank account, or
(2) arranges for a bank line of credit or

(3) sell a liquid financial asset and use the money to replenish one’s bank account.

Since the future is uncertain, individual decision makers never know when they might be suddenly faced with a contractual payment obligation at a future date that they did not, and could not, anticipate and that we could not meet out of the cash inflows expected at that future date. Or if an expected cash inflow suddenly disappears for any unexpected reason: e.g., a reduction in pension income due to financial market value declines, or a loss of job, or the death of the breadwinner in the family, or government austerity program impacts the decision maker’s cash inflow, or an asset that we held in our portfolio that we thought could easily be sold suddenly becomes illiquid.

Accordingly there is a precautionary liquidity motive for maintaining a positive bank balance in order to protect against an unforeseen catastrophe. In our society, no one can either be too handsome, or too beautiful or too liquid. As long as the future is uncertain, enhancing our liquidity position to cushion the blow of any unanticipated events that may occur is an understandable human activity. The more we fear the uncertain future, the bigger cushion we desire.

The primary function of well-organized and orderly financial markets is to provide liquidity so that holders of financial assets traded on such markets “know” they can make a fast exit and liquify their portfolio at a price close to the previous market price. For business firms and households the maintenance of one’s liquid position is of prime importance if insolvency and bankruptcy is to be avoided. In our world, bankruptcy is the economic equivalent to a walk to the gallows [Although my good monetarist friend, Allan Meltzer always tells me “Bankruptcy is good for capitalism” – and he must have convinced Mitt Romney of that since Romney argued that it would be
good for Detroit’s auto industry to go bankrupt and through a usual restructuring–(perhaps helping to break union contracts?).

Post Keynesian theory emphasizes that in order for a financial market to be a truly liquid market, the market must well organized AND orderly. To assure orderliness, there needs to be an institution–an institution–a market maker–who has sufficient resources that when many private sector holders are trying to make a fast exit, (i.e., there are not enough bulls to allow the bears to make an orderly exit) the market maker steps in and buys to maintain orderliness in the market. If this private sector market maker’s own resources are insufficient to maintain orderliness when there is a “herd behavior” rush to the exit, then trading is usually suspended via circuit breakers until the market maker can obtain sufficient resources to maintain orderliness and/or the panic subsides. If the market maker cannot restore order to an important financial market then it is the central banker who may have to become the market maker of last resort to either directly, or through providing resources to the market maker, restore orderliness.

In 2007 the markets for mortgage backed derivative financial assets were usually well organized by private investment bankers but, these derivative markets lacked any market maker who was willing to stay the course to maintain orderliness. Nevertheless, these mortgage backed derivatives were advertised to be “as good as cash” i.e., perfectly liquid (and triple A rated) and therefore banks and other financial institutions around the global held these “liquid”derivatives for their potential yields and safety. When the sub-prime mortgages in some of these derivatives went into default, the market for mortgage backed derivatives collapsed. Holders of these financial derivative assets tried to make a fast exit. While no one would buy these derivatives. The loss of liquidity initially for a few of these derivative securities panicked the market causing a cascading effect
for other derivatives securities that had been previously thought to be very liquid. There were not enough remaining bulls to offset the rush of the bears. With no apparent market value, the mark to market accounting rule threatened the balance sheet of many financial institutions with insolvency and bankruptcy. The result is financial collapse and crisis. Without the market maker of last resort, i.e., the central bank, stepping in, financial collapse is inevitable.

In an international setting, if there is not be a supranational central bank that will act as the market maker last resort for government securities and restore order, then the nation must strive for an over abundant accumulation of foreign reserves if a country wants to be sure it has enough liquidity to meet all possible future international contractual obligations.

In the Keynes analysis of our entrepreneurial economy, savings out of current income that becomes a demand for liquidity is, in effect, a reduction in effective demand for producible goods and services. Why? In Chapter 17 of Keynes’s General Theory entitled “The Essential Properties of Interest and Money”, all liquid assets had two essential properties (1) a zero (or negligible) elasticity of production and (2) a zero elasticity of substitution between liquid assets and producible goods. The zero elasticity of production means that if, for example, consumers reduced their spending on the space vehicles that we call automobiles in order to increase their savings out of income and use their savings to buy liquid time vehicles (liquid assets that move contractual settlement power over time into the future), then entrepreneurs will reduce hiring in Detroit as demand for autos decline, but there will be no increase in hiring of workers to produce more time vehicles in response to the increase in demand liquid assets to move purchasing power over calendar time.
In classical general equilibrium analysis, the money numeraire is often said to be peanuts – a commodity that possesses a positive elasticity of production. In such a theoretical world, if the demand for autos fall, the resulting increase in savings out of income will increase the demand for peanuts. Accordingly unemployment in Detroit will be offset by a rise of employment in the peanut fields of Georgia and Alabama. If this was truly the world of experience, then when President Jimmy Carter found the economy enmeshed in a recession, he should have installed his Brother Billy Carter (a peanut farmer) to be head of the Federal Reserve rather than Paul Volker!

SOROS AND REFLEXIVITY

George Soros has explained why the efficient market theory is not applicable to real world financial markets with a slightly different terminology than Keynes but conceptually in the same way. Soros (2008) wrote: “we must abandon the prevailing [efficient market] theory of market behavior.”. Soros states that there is a direct connection “between market prices and the underlying reality [that] I [Soros] call reflexivity”.

What is this reflexivity? In a letter to the Editor published in the March 15-21, 1997 issue of The Economist Soros objects to Paul Samuelson insistence on applying the ergodic axiom to economics because Soros argues the ergodic hypothesis does not permit “the reflexive interaction between participants’ thinking and the actual state of affairs” that characterizes real world financial markets. In other words, the way people think about the market can affect and alter the future path the market takes. Soros’s concept of reflexivity, therefore, is the equivalent of Keynes’s throwing over of the ergodic axiom. Reflexivity means peoples thoughts and actions create the future, while
the mathematical risk management models presume that the computer models can discover the future that has already been predetermined by historical market fundamentals.

INTERNATIONAL TRADE

In the international sector, nations often have a fear of being unable to meet unknown future international contractual commitments. Accordingly, such nations attempt to grow and accumulate liquid foreign reserves by “making” their industries more competitive vis-a-vis foreign firms. Hopefully this competitive advantage will increase exports more rapidly than any growth in imports leading to a favorable balance of trade and an accumulation of internationally liquid foreign reserves. (President Obama said he wants foreigners to buy more “Made in America” goods so as to increase employment in the USA.)

But, as Keynes noted [1936, pp. 338-339], a system of free trade is likely to encourage policies to promote “an immoderate competition for a favorable balance which injures all alike”8 So just as oversaving by individuals in a closed economy can lead to economic depression, accumulation of foreign reserves (a nation’s savings) can create a tendency to depress the global economy.

It is claimed that if some nations are running persistent trade deficits and each nation has its own currency, then the market would encourage a devaluation of the deficit nation’s currency. The result will be to make the industries in the deficit nation “more competitive”. Some believe the solution to the Greek deficit problem is for it to exit the Euro, restore the drachma as the nation’s currency, and devalue the drachma relative to the Euro to make Greek industries competitive. [Alternatively, if the Greeks do not exit the Euro, they should be forced to adopt a stringent austerity
program that will cause so much domestic unemployment, that the average Greek wage in Euros will decline significantly making their industries more competitive.] But more competitive to who?

This devaluation argument implies that the previously more competitive industries in the surplus nation(s) will become less competitive and even possibly so unprofitable that they may often go bankrupt merely because their nation’s trading partner has devalued. In the 1930s this striving for competitiveness via devaluation wars was known as “exporting your unemployment”.

In the brief time I have here, I wish to indicated some principles behind the Bretton Woods “Keynes plan” for a global monetary payments system. I will not have time to develop Keynes’s plan or present my version for 21st century international payment institutions that would follow Keynes’s principles to lead to a world of global economic prosperity. I hope only to have stimulated your interest to read further about these matters.

Let me, however, remind you of what Keynes indicated was necessary to achieving domestic full employment in an open economy system.

(1) for each nation to pursue a full employment prosperity policy what is necessary is an autonomous rate of interest domestically set without any preoccupation to international complications. [Keynes, 1936, p. 349], i.e., the possibility of capital flow controls,

(2) Except for natural resources and climate related industries, the law of comparative advantage is not important. For “an increasingly wide range of industrial products....[e]xperience accumulates to prove that most mast production processes can be performed in most countries and climates with equal efficiency” [Keynes, 1933, p. 238]. Note the implication for offshoring and outsourcing!

REFORMING THE WORLD’S MONEY - THE BRETON WOODS EXPERIENCE
Too often economic discussions on the requirements for a good international payments system that will eliminate persistent trade and international payment imbalances have been limited to the question of the advantages and disadvantages of fixed vs. flexible exchange rates. US Treasury Secretary Geithner apparently believes if the Chinese would let the market decide the yuan-US dollar exchange rate, the problem of US running an unfavorable balance of trade would be resolved. This assumes that raising the yuan relative to the dollar will offset the cost advantage Chinese factories have in producing in sweatshop conditions without any occupational safety conditions, with child labor, and polluting the surrounding environment.

If China was to build a factory in California and operate it the way it is operated in China, US laws that require treating labor and the environment in a civilized manner would prohibit this Chinese factory from selling its goods in America!

In championing the argument for flexible exchange rates economists assume that the price elasticities of the demand for imports and exports will meet the Marshall-Lerner condition, at least in the long run. For example in a book co-authored by Ben Bernanke [1992, p. 50, emphasis added] it is stated that

“[a] fall in the exchange rate tends to reduce net exports in the short run....After consumers and firms have had more time....the Marshall-Lerner condition is likely to hold and a fall in the exchange rate is likely to lead to an increase in net exports.”

How “likely” is the applicability of the Marshall-Lerner condition to the situation is therefore important in deciding whether a policy of flexibility in the exchange rate has anything to recommend it even in the long run. The facts of experience since the end of the Second World War plus Keynes's revolutionary liquidity analysis indicates that more is required then merely a
devaluation, if a mechanism is to be designed to positively resolve otherwise persistent trade and international payments imbalances while simultaneously promoting global full employment, rapid economic growth, and a long-run stable international standard of value.

Since the Second World War, the economies of the capitalist world has conducted experiments with the different types of exchange rate systems. For more than a quarter of a century (1947-1973) after the war, nations operated under the Bretton woods Agreement for a fixed, but adjustable, exchange rate system where, when necessary, nations could invoke widespread limitations on international financial movements (i.e., capital controls). Since 1973, the conventional wisdom of economists and politicians is that nations should liberalize all financial markets to permit unfettered international capital flows to operate under a more freely flexible exchange rate system.

In contrast to this recent view of the desirability of liberalized markets, Keynes’s position at the Bretton Woods conference suggested an incompatibility thesis. Keynes argued that free trade, flexible exchange rates and free capital mobility across international borders will be incompatible with the economic goal of global full employment and rapid economic growth.

Between 1947 and 1973 policy makers in their actions implicitly recognized Keynes’s ‘incompatibility thesis”. This period was a “golden age” era of sustained economic growth in both developed and developing countries. The free world's economic performance in terms of both real growth rates per capita and price level stability during this 1947-1973 period of fixed, but adjustable, exchange rates was historically unprecedented\(^9\). The disappointing post-1973 experience of persistent high rates of unemployment in many nations, bouts of inflationary pressure and slow growth in many OECD countries, plus debt-burdened growth and/or stagnation (and even falling real
GNP per capita) in some developing countries and finally an international financial collapse contrasts sharply with the experience during the Bretton Woods period.

The significantly superior performance of the free world's economies during the 1947-1973 fixed exchange rate period compared to the earlier gold standard fixed rate period suggests that there must have been an additional condition besides exchange rate fixity that contributed to the unprecedented growth during the 1947-73 period. That additional condition, as Keynes explained in developing his “Keynes Plan” required that any creditor nation that runs persistent favorable trade payments must accept the major responsibility for resolving these trade imbalances. Conventional mainstream theory, on the other hand, argues that the nation running an unfavorable balance of trade must accept the major responsibility for resolving the problem, even though the trade surplus nation has the wherewithal readily available to resolve the problem..

The Marshall Plan was an instance where the creditor nation adopted the responsibility that Keynes had suggested was required. The result was a golden age of economic growth for the USA and the member nations of OECD. When, in 1973, the U.S. withdrew from the Bretton Woods Agreement, the last vestiges of Keynes's enlightened monetary approach were lost, apparently without regret or regard as to

[a] why the Bretton Woods system had been developed in the first place and

[b] how well it had helped the free world to recover from a devastating war which had destroyed much of the productive stock of capital in Europe and Asia.

Under any traditional international free trade system, any nation that attempts to improve its economic growth performance by pursuing Keynes's policies for increasing domestic effective
demand via easy monetary and fiscal policies will almost immediately face an international payments problem. Expanding domestic aggregate demand will increase the demand for imports relative to the value of exports. When a nation’s imports persistently exceed its exports, the nation typically requires foreign loans to finance this import surplus that is encouraging increased economic growth in the trading partners’s export industries.

Since 1981 the United States has been the “engine of growth” for most of the rest of the world, as U.S. perpetually ran an unfavorable trade balance as U.S. imports tended to grow more rapidly than its exports. Accordingly, the United States has been saddled by increasing international deficits almost every year for its laudatory efforts.

Unfortunately, time will not permit me to discuss my version of Keynes’s international payments system proposal that will promotes global full employment in the 21st century, so I will end here. If you want to know more about this international payments proposal see my book THE KEYNES SOLUTION: THE PATH TO GLOBAL ECONOMIC PROSPERITY.

Finally it should be noted that, in any accounting period, if there is aggregate net savings in the private sector of a nation, then the private sector savings is, in essence a demand for additional liquid financial assets. This savings demand for liquidity can only be validated without a fall in GDP by another sector (either government or the foreign sector) spending more than its income on goods and services (and thereby increasing its outstanding financial liability contracts). In the absence of debt financed purchases of goods and services by either government or foreigners, this domestic demand for savings in the form of liquid assets leads to a decline in effective demand. [Thus the US should not be grateful to China for lending us money to
permit the government to finance big government’s purchase of goods and services. Instead China should be grateful that the US deficits extended global effective demand to keep Chinese factories humming.]

NOTES

2. Greenspan stated: “This crisis, however, has turned out to be much broader than anything I could have imagined.... In recent decades, a vast risk management and pricing system has evolved, combining the best insights of mathematicians and finance experts supported by major advances in computer and communications technology. A Nobel Prize was awarded for the discovery of the [free market] pricing model that underpins much of the advance in [financial] derivatives markets. This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed.”

3. Milton Friedman comes to the opposite conclusion by using a definition of savings in a way that differs from Keynes’s taxonomy and the language of ordinary people. Friedman defines consumption as “the value of [utility] services consumed today “, i.e., nondurables plus the amount of existing durables that wear out today –or the accounting period. Savings is measured by anything that is purchased today that is not entirely consumed today. [M. Friedman, The Permanent Theory of Income (1957, Princeton University Press, pp., 28. Friedman states that his taxonomy is superior because “much that one classified as consumption is reclassified as savings”.

4. Nobel Prize winner Robert Lucas [1981, p. 287] has boasted that mainstream theory axioms such as the ergodic axiom are “artificial, abstract, patently unreal”. Like Nobel Laureate Samuelson, Lucas insists such unreal assumptions are the only scientific method of doing economics. Lucas states that “Progress in economic thinking means getting better and better abstract, analogue models, not better verbal observations about the real world” [Lucas, 1981, p. 276]. Unrealistic assumptions make the problem more tractable mathematically and, with the aid of a computer, the analyst can then statistically predict the future. Never mind that the prediction might be wrong.
Yet the Great Depression of the 1930s was preceded by a real estate monetary value market bubble and a stock market nominal bubble. Moreover, the Great Recession of 2007-2010 was preceded by a dot.com monetary bubble and a sub prime mortgage real estate bubble. How is this possible?

In mainstream macroeconomics, contracts are always made in real terms as no agent is suffering from “the money illusion”.

In place of the rejected ergodic axiom Keynes argued that when crucial economic decisions had to be made, decision makers could not merely assume that the future can be reduced to quantifiable risks calculated from already existing market data.

For decisions that involved potential large spending outflows or possible large income inflows that span a significant length of time, people “know” that they do not know what the future will be. They do know that for these important decisions, making a mistake about the future can be very costly and therefore sometimes putting off a commitment today maybe the most judicious decision possible.

Our modern capitalist society has attempted to create an arrangement that will provide people with some control over their uncertain economic destinies. In capitalist economies the use of money and legally binding money contracts to organize production, sales and purchases of goods and services permits individuals to have some control over their cash inflows and outflows and therefore some control of their monetary economic future.

Thus, as the biographer of Keynes, Lord Robert Skidelsky has noted, for Keynes “injustice is a matter of uncertainty, justice a matter of contractual predictability”. In other words, by entering into nominal contractual arrangements people assure themselves a measure of predictability in terms of their contractual cash inflows and outflows, even in a world of uncertainty.

President Obama has indicated that he would adopt policies to double US exports by the year 2014 by making US industries more competitive. At whose expense?

See Irma Adelman [1991]

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