An Introduction to Post-Keynesian Economics

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Post-Keynesian Economics. A preview

- After publication of General Theory discussion on interpretation of Keynes’ theory
  - Involuntary unemployment, financial crisis
  - Hicks develops ISLM; mainstream Keynesianism: neoclassical-Keynesian Synthesis, later New Keynesian Econ
- PKE emphasises break of Keynesian theory from neoclassical theory
  - Reject need for microfoundations of macroeconomics
- Developed by the collaborators of Keynes (Joan Robinson, Kaldor, Kahn; Kalecki)
- Initial project: turn Keynes’ theory from a short run theory to longer term theory
  - develop a Keynesian growth theory
  - Criticise neoclassical theory of income distribution (Cambridge Capital Controversies)
- School formation in 1970s
- Theory of endogenous money creation
- Financial instability and financial cycles (Minsky)
- Analysis of demand regimes (Kalecki)
- Adjustment of supply to demand, even in long run (Kaldor)
Outline

• Foundations
  • Fundamental uncertainty
  • social conflict, heterogeneity, and institutions
  • Effective demand

• Macroeconomics
  • Investment → savings
  • Involuntary unemployment
  • Credit → money
  • Financial instability
  • The supply side: hysteresis and cumulative causation

• Outcomes: some paradoxes

• Economic Policy
Post Keynesian Economics

Effective demand

Fundamental uncertainty

Classes + institutions
Fundamental uncertainty

• ‘we simply don’t know’
  • That’s a statement about the world, not about human cognitive abilities
• → animal spirits: people can’t be ‘rational’, instead
  • They rely on conventions (heuristics) = look what other people are doing (social norms, anchoring, institutions)
  • Assume that the future is similar to the past (adaptive expectations)
  • Conventions can change rapidly (herd behaviour)
  • Modelling: self-fulfilling prophecies and interaction of different rules of expectation formation (Franke and Westerhoff 2017)
• Money as a means to deal with uncertainty → liquidity preference
  • Possibility of liquidity crises and panic
• Investment demand driven by animal spirits
  • Can’t make a ‘rational’ decision about long time horizon
Classes, social conflict and institutions

- PKE in political economy tradition: class analysis instead of methodological individualism
  - Social conflict: classes, gender, … heterogeneity
  - Heterogeneity: both in expectation formation and in social class
    - Interactions with ABM, e.g. ‘Schumpeter meet Keynes’ models by Dosi et al 2010)
- PK models: often 3 classes: workers, capital, rentiers/finance
  - Capital hires labour; firing threat as disciplinary advise
  - Capitalists make investment decisions
  - Rentiers advance capital and receive interest + dividend payments
  - Have different consumption propensities
- Institutions regulate and mediate conflicts
- Inflation as the outcome of unresolved distributional conflicts
- Note: workers and uncertainty? job insecurity
Effective demand

- \( I(Y) = S(Y) \)
- Investment \( \rightarrow \) savings via multiplier process
  - Investment forward looking: expectations
  - Investment not constrained by saving, but possibly by the availability of finance
  - Investment expenditures are the single most important determinant of fluctuations in GDP
  - Have strong non-rational component; interest effects minor
- Saving: passive; different saving propensities according to income
  - Distribution matters (possibility of wage-led demand)
- Private goods market equilibrium will in general not be at a full employment equilibrium
UK: investment, consumption, GDP
Involuntary unemployment

- Labour market is not self-adjusting; cannot serve as the anchor of the economy
- Wage contract are nominal contracts
- Wage cuts $\rightarrow$ reduction in consumption demand
  - $\rightarrow$ downward pressure on prices
  - $\rightarrow$ possibility of debt-deflation spiral
- Real wage cut: workers have higher MPC than capitalists
  - $\rightarrow$ real wage cut will be contractionary unless investment is very sensitive to profit margins
  - In demand regimes analysis: possibility of a wage-led demand regime
- $\sum$ No (or weak) self adjustment towards full employment
- Labour market dragged along with goods market; strong hysteresis
Distribution and growth: demand regimes

- PKE rejects marginal productivity theory of income distribution
  - Distribution of income is determined by power relations (market power of firms, organisational strength of labour unions)
  - Level of income determined by macroeconomic conditions (animal spirits, investment expenditures)
- Demand regimes (Bhaduri and Marglin 1990): dual role of wages
  - A cost for firms (Investment financed by credit and by profits)
  - Source of income for households (Workers consume most of their income)
- Higher wages will have
  - Positive effect on consumption
  - (possibly) negative effect on investment
  - Negative effect on net export
- Overall effect on GDP can be positive or negative depending on relative size of these effects: wage-led as well as for profit-led demand regimes possible
- Extensions to include debt-driven and export-driven growth models (Lavoie and Stockhammer 2013)
Money and finance

- Uncertainty → liquidity preference
  - Money held in times of increased uncertainty

- Endogenous money: credit → money
  - CB sets the interest (base) rate
  - Private financial institution mark up according to their liquidity preference (risk premium)
  - Elastic finance allows for investment booms as well as for speculative asset price booms

- Financial markets prone to instability b/e forward looking (fundamental uncertainty)
  - Debt cycles a la Minsky
  - Financial innovation in boom allows to increase leverage
UK: cycles in rLoans and rGDP
Source: Haldane (2012 BIS WP)
Endogeneous financial cycles

- Keynes: theory of financial crisis, collapse of confidence, rush to safety (liquidity preference)
- Hyman Minsky develops this into a theory of endogenous financial cycles
  - Mainstream (DSGE) financial crises due to exogeneous shocks
- Debt cycles: during boom investors become willing to take more risk = higher leverage = system become more fragile → endogenous boom-bust cycles
  - Stockhammer, Calvert Jump, Cavallero and Kohler (2019): use minimalist (2D) Minsky model to test for endogenous cycles (oscillations): evidence for business debt-GDP cycles for USA and Australia
- speculative asset price cycles: momentum trader models
  - Ryoo (2016) as Minskyan macro model with speculative housing cycles
The supply side

- Economy demand-led even in long run
  - Does not deny role of supply-side factors in long run
- supply adjusts to demand shocks
Path dependent growth
(Figure from Blanchard et al 2015)

Figure 3: United States – Evolution of log real GDP and Extrapolated Trends
The supply side

- Economy demand-led even in long run
  - From neoclassical perspective: “medium run”
- Independent investment function in growth models
- Supply adjusts to demand shocks
  - **Unemployment hysteresis** → endogenous NAIRU; endogenous labour supply (LF participation, migration)
  - **Endogenous labour productivity**: induced technical change; dynamic returns to scale (learning by doing), Kaldor-Verdoorn effects
- **Latin-American Structuralism**: structural differences between core and periphery countries (different sectoral specialisations, associated with different export and import elasticities)
- Balance of Payment constraint growth models (Thirlwall): long-term growth determined by X,M-elasticities (and thus international division of labour)
Results: paradoxes of market economies

- Market economies do not gravitate towards full employment equilibrium
- **Paradox of thrift** (Keynes): increase in individual saving propensities can lead to decline in aggregate saving
- **Paradox of cost** (Kalecki): increase in wage can lead to increase in profits (“wage-led demand regime”)
- **Paradox of debt** (Steindl, Koo): attempt by firms (indebted units) can lead to depression and thus rising debt ratios
- **Paradox of tranquillity** (Minsky): stability breeds instability as it encourages more risky behaviour
- Endogenous financial cycles
- Long-lasting demand shocks, Possibility of ‘secular stagnation’
## PK and mainstream economic policy

<table>
<thead>
<tr>
<th></th>
<th>Mainstream Policy Mix</th>
<th>Post Keynesian Policy Mix</th>
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</thead>
<tbody>
<tr>
<td><strong>Overall aim</strong></td>
<td>Efficiency (minimal interference in markets)</td>
<td>Full employment</td>
</tr>
<tr>
<td><strong>fiscal policy</strong></td>
<td>Balanced budgets (‘sound fiscal policy’)</td>
<td>Countercyclical fiscal policy to ensure full employment</td>
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<tr>
<td><strong>Monetary policy</strong></td>
<td>Inflation targeting</td>
<td>Has to support growth; In recession with debt hangover: higher inflation to simplify deleveraging</td>
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<tr>
<td><strong>Labour market</strong></td>
<td>Encourage ‘labour market flexibility’</td>
<td>Institution building</td>
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<td></td>
<td>Wage as a cost factor</td>
<td>Wages as source of demand</td>
</tr>
<tr>
<td><strong>Financial market</strong></td>
<td>financial liberalisation, trusts efficiency of financial markets</td>
<td>Regulation has to ‘lean against the wind’ (macroprudential policies)</td>
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PKE – wrapping up

• foundations
  • Rejects representative agent optimising microfoundations for macro
  • Fundament uncertainty + sociological/class-analytic foundations

• Macroeconomics
  • Investment $\rightarrow$ savings
  • Involuntary unemployment
  • Credit $\rightarrow$ money
  • Financial instability: endogenous financial cycles

• Long-lasting demand shocks, possibility of ‘secular stagnation’
• Need active fiscal policy, monetary policy to lean against financial cycle
Reading suggestions

classics
• Keynes: General Theory of Employment, Interest and Money
• Kalecki: Theory of Economic Dynamics
• Robinson: Accumulation of Capital
• Minsky: Stabilizing an Unstable Economy

Introductions, surveys, history
• Lavoie: Introduction to Post Keynesian Economics
• Hein & Stockhammer: A New Guide to Keynesian Macroeconomics and Economic Policies
• King: History of Post Keynesian Economics
A bit more history and differences to other paradigms
# Neoclassical vs Keynesian theory

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<thead>
<tr>
<th></th>
<th>Neoclassical theory</th>
<th>Keynesian theory</th>
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<tbody>
<tr>
<td>Key concepts</td>
<td>Rational behaviour, equilibrium</td>
<td>Effective demand, ‘animal spirits’</td>
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<tr>
<td>Behaviour</td>
<td>Rational behaviour by selfish individuals</td>
<td>‘animal spirits’ (non-rational behaviour) and conventional</td>
</tr>
<tr>
<td>Markets</td>
<td>Market clearing ← price adjustment</td>
<td>Some markets don’t clear</td>
</tr>
<tr>
<td>Money</td>
<td>Classical dichotomy (money is neutral)</td>
<td>Endogenous money creation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Endogenous financial instability</td>
</tr>
<tr>
<td>unemployment</td>
<td>Voluntary or due to rigidities</td>
<td>Involuntary, due to lack of demand on goods markets</td>
</tr>
<tr>
<td>policy</td>
<td>Laissez faire: markets are self-regulating and gov’t should not intervene</td>
<td>market economies are unstable and result in unemployment → gov’t should intervene</td>
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New Keynesian Econ

- Estranged cousins of PKE
- reaction to New Classicals - accept microfoundations and often rational expectations
- but assumes (or derives) imperfect markets –
  - menu costs,
  - NAIRU, insider outsider models
  - credit rationing / asymmetric information
- in 1980s: many partial equilibrium models (Mankiw, Blanchard, Stiglitz, Fisher)
- 1990s: “New Consensus Model” (New Keynesian-Neoclassical Synthesis) and DSGE
  - short run/long run dichotomy, but with strict microfoundations
  - Pseudo IS curve: downwards sloping because of intertertemporal consumption
- Since 2008: rediscovering PK arguments: hysteresis, financial instability
PK: development and streams

- 1950s + 60s: Keynes in the long run – distribution and growth;
  - Capital Controversies;
  - critique of neoclassical-Keynesian Synthesis (ISLM etc)
  - Where? Cambridge
- 70s + after: formation of PK school (journals); spreading out
  - Where? Lost Cambridge -> spreading out (USA, continental Eu..)
  - Conflict inflation; endogenous money
  - Shift towards short/medium run analysis (Kaleckian models): distribution and demand, wage-led growth
  - Financial instability (Minsky)
  - More on economic policy, more empirical
- Streams
  - Sraffians: long run, distribution, technology and prices
  - Monetary Keynesians (incl. Minsky): uncertainty, money, short term
  - Kaleckians: social conflict, distribution, demand; short/medium term
  - Various other (often narrower streams): BoPC growth, SFC, MMT …
<table>
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<tr>
<th>PKE</th>
<th>Marxian econ</th>
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<tbody>
<tr>
<td><strong>scope</strong></td>
<td>Economic theory</td>
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<tr>
<td><strong>Demand</strong></td>
<td>Effective demand</td>
</tr>
<tr>
<td><strong>Production</strong></td>
<td>Little to say to production</td>
</tr>
<tr>
<td><strong>Class analysis</strong></td>
<td>classes have different consumption propensities; only capitalists make investment decisions</td>
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<tr>
<td><strong>Money &amp; finance</strong></td>
<td>Money is created by banks as side effect of lending</td>
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<td></td>
<td>Money to deal with uncertainty</td>
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<tr>
<td><strong>unemployment</strong></td>
<td>Lack of effective demand; no tendency to full employment</td>
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<tr>
<td><strong>policy</strong></td>
<td>Normative: full employment policy; can also benefit capital</td>
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