

Post-Keynesians and New Keynesians: Problems in translation or irreconcilable differences?

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Farmer 2017

- “Post Keynesian finches and their New Keynesian cousins have avoided each other for far too long. ... it is my hope that the shock of the Great Recession will catalyze interbreeding between new-Keynesian and heterodox economists.” 14
- “.. make the case for unity between Post-Keynesian and General Equilibrium Theory under the banner of Post-Keynesian Dynamic Stochastic General Equilibrium Theory.”

outlook

- Where is PK today?
- Comments on Farmer (2017)
- Wrapping up: comments on PK and NK

Where is PK?

- PK has a well defined core
 - principle of effective demand,
 - fundamental uncertainty, animal spirits, liquidity preference
 - Endogenous money creation
 - Endogenous financial instability,
 - independent investment function in the long run,
 - class-specific saving propensities -> allows for wage-led demand regimes
 - hysteresis (natural rate endogeneity) in the long period...
- Note: that's different from other heterodox streams that are often more heterogenous (Ecological Econ, Feminist Econ, Marxism...)
- It has set of journals and network of associations and conferences
- But is marginalised by the mainstream and has little impact on policy making

Where is PK: what has changed since 2008?

- Marginalisation has not changed much since the Financial Crisis 2008
- Essentially no opening of economics as an academic discipline in terms of hiring; mainstream journals still closed to PKE (in particular in macro)
- Some increased interest by policy institutions (BoE, ILO...), but ultimately marginal
- Some increased interest by progressive parties, but no substantial impact on policy
- Today's PK generation has few personal links to leading mainstream economists (different for previous cohort)

Strong/weak ties, fragmentation ... PK ghetto?

- Granovetter (1973): 'the strength of weak ties'
- Strong ties are often within networks; strong ties "breed local cohesion, lead to overall fragmentation" (p. 1378); bridge to other networks are usually weak ties
- Illustrates importance of weak ties (rather than of strong ties) with respect to job search and the ability of different ethnic communities to organise here against community damaging building projects
- In this terminology PKE has a lot of strong ties, but few weak ties
- Kapeller and Dobusch (2012): citation analysis: most heterodox streams references their own stream and mainstream (who doesn't cite them), but not other hetecons

Some green shoots (weak ties)

- Exciting interaction with ABM/Evolutionary Econ (but driven more by ABMs) (Caiani et al 2016, Dosi et al xxx)
- SFC modelling gives some excess to policy institutions and financial sector (Godley and Lavoie 2007, Burgess et al 2016)
- Ecological Macroeconomics (a niche program) has strong PK showing (Hardt and O'Neill 2017, Dafermos et al 2017)
- Feminist Econ and PK (Braunstein et al 2011)
- Political Scientists show interest in PK demand regimes (Baccaro and Pontussen 2016)
- ... but these are few
- Short, PKE must reach out

Farmer on New Keynesian econ

- Farmer: “New-Keynesian economics was constructed on the core of a representative agent real business cycle model by a group of neoclassical economists, notably Michael Woodford in his Magnus opus *Interest and Prices*.”
- “New-Keynesian economics is built on two assumptions. The first is that aggregate quantities can be modeled ‘as if’ they were chosen by a single optimizing household with superhuman perceptions of future prices. The second is that an ‘evil agent’ throws sand into the adjustment process and prevents prices from quickly moving to equate the demands and supplies of all commodities.”
- *This equates NK with NK-DSGE*

New Keynesian Econ

- Accept need for microfoundations of macro
- Takes market-clearing equilibrium as reference point
- In 1990s (Mankiw and Romer 1991): bewildering variety of partial equilibrium models sticky prices, staggered wage setting, credit rationing, financial accelerator, efficiency wages, NAIRU, multiple equilibria, noise trader models...
- In 2000s variety of NK models turns into NK-DSGE (ok, maybe ZLB)
- ‘even if...’ model turned into THE benchmark model
- Still lots of interesting, empirically driven ‘NK’ work: de Long and Summers 2012 on fiscal policy; Blanchard et al 2016 on hysteresis; Piketty, Saez on inequality; Haldane, Borio on financial instability; Cecchetti and Kharroubi 2012 on financial development; Jorda et al 2013 JMCB on debt and recessions; Ostry et al 2014 on inequality and growth

Farmer's project

- Recover some Keynesian arguments, in particular role for animal spirits and unemployment equilibria, in a DSGE setting
- Accepts representative agent
- Accepts 'rational expectations'
- "A model, populated by overlapping generations of finitely lived people, always has multiple equilibria."
- Uses search and matching labour market
- Replaces bargaining equation with belief function (animal spirits)
- Multiple equilibria (with different unemployment rates!) and animal spirits matter
- Attack on natural rate hypothesis/NAIRU (in BoE)

Farmer on PK

- “When did Post-Keynesians stop interbreeding with their orthodox cousins? It was in 1955. That was the year when Paul Samuelson introduced the neo-classical synthesis into the third edition of his influential introductory textbook”
- *That’s misleading, There was exchange between PK and old Keynesian until the 1970s, Cambridge capital controversies etc; the line went silent with the New Keynesians and microfoundations*

Farmer on PK

- Want NK and PK crossbreeding
- *paper where the references include one single PK (Minsky)*
- “Post Keynesians are not big fans of general equilibrium theory. Their antagonism to the equilibrium approach stems, I believe, not from the concept of equilibrium, but from the concept of efficiency.
- *No, PKs are not comfortable with GE because either they reject the notion of an aggregate production function or they think that the economy is normally at point with excess capacity, i.e. not on the production function.*
- *PKs reject complete future markets and consumption function that allow for intertemporal optimisation*

Farmer on PK

- “Post Keynesians have been vehement critics of the rational expectations hypothesis but I am inclined to accept it as a working assumption in order to focus on a more important issue”
- *Some PK have been highly critical of RE (Davidson...) others (Palley) have highlighted that the core difference is about whether markets are clearing, not whether expectations are model-consistent.*
- *PKs object to strong rationality assumptions, in particular intertemp optimisation as unrealistic. Instead heuristics*

Farmer on animal spirits

- Animal spirits = belief function

$$x_t \equiv E_t \left(\frac{p_{k,t+1}}{w_{t+1}} \right)$$

- Not distinction between equity price and price of machinery
- Animal spirits is about stock market shock

$$x_t = x_{t-1}^\lambda \left(\frac{p_{k,t}}{w_t} \right)^{1-\lambda} \exp(s_t^b) \quad s_t^b \sim D(0, \sigma_b^2)$$

- Animal spirits have random shocks and mean zero, follow a adaptive expectations updating
- In order to show how self-fulfilling prophecies can arise

Farmer's labour market

- “The labor market is not an auction in which a fictitious character asks buyers and sellers to submit demands and supplies until he has found a set of market-clearing prices. It is a search market in which buyers and sellers are randomly matched.
- “In classical search theory, the absence of prices to determine the allocation of job search between unemployment and vacancies, is replaced by the assumption that workers and firms bargain over wages.
- “In Keynesian search theory the multiplicity is resolved, instead, by assuming that beliefs about the future value of the stock market is a new fundamental.

- “Animal spirits are fundamentals that should be granted the same methodological status as technologies, preferences and endowments.
- “An important research question for macroeconomics is: what are the determinants of the aggregate demand curve and why does it shift around in sometimes unpredictable ways over time?
- “In my view, Keynes’ theory of the consumption function is inadequate to answer this question. We should instead explicitly model the connections between consumption and wealth.

How Keynesian is Farmer?

- Insists on non-auction labour markets and multiplicity of equilibrium unemployment rates
- Has key role for 'animal spirits': some sets of expectations about the future that can generate self-fulfilling prophecies
- Macro shocks are about expectations, stock markets and ... consumption (wealth effects)
- Farmer's animal spirits shocks are investment shocks, but affect consumption
- Labour market: matching model -> involuntary unemployment, but that is frictional unemployment; does away wage bargaining.
- As other NK-DSGE: sort-of-Keynesian outcomes, but not with Keynesian mechanisms
- Challenges for PKs: Farmer models self-fulfilling prophecies
- Farmer shows one way of integrating search labour market into a Keynesian macro model

PK vision

- Heterogeneous agents: workers vs capital owners, fundamentalists vs momentum traders, different investment strategies
- Realist behavioural assumptions rather than axiomatic rationality
- Independent investment function; demand shocks are primarily investment shocks
- Incomplete financial markets: workers' consumption depends primarily on current income (household debt and mortgages matter, but doubtful if that is due to rational optimising behaviour)
- Endogenous instability of financial markets
- Labour market: wage bargaining with endogenous NAIRU

Concluding: PK and NK

- PKs is intellectually established, but effectively marginalised. We need to reach out (other hetecons, other social sciences, policy makers, mainstream econ)
- Depressing that Global Financial Crisis has changed little in the marginalisation of PK (and other hetecons)
- NK has re-invented several PK wheels (credit rationing, endogenous money, debt cycles, NAIRU, hysteresis); the lack of acknowledgement may be unpleasant, but knowledge is public good ... *what can we learn from them?*
- NK has accepted the microfounded terrain of neoclassical econ, which has resulted in a fertile research program
- DSGE is not the most attractive part of NK research
- PKs should confront their implicit micro assumptions -> heterogeneous agents and incomplete markets -> ABM, de Grauwe and Macchiarelli 2015
- Theoretical macro is a very hostile habitat for PKs -> need to strengthen empirical research