

Solving crises – it's easy!

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You see the cause of slumps under capitalism is easy to discern and, as a result, what to do to avoid them is also straightforward. John Maynard Keynes sorted this out nearly 70 years ago – and without any reference to Marx or any other theorist of crises.

So says Philip Pilkington in a recent post on his blog (*Keynes' Theory of the Business Cycle as Measured Against the 2008 Recession*). Pilkington is a research assistant at Kingston University and member of the Political Economy Research Group (PERG) at Kingston University, a UK centre of radical post-Keynesian economists, with its economics department now headed by the brilliant Steve Keen (see my post, <http://thenextrecession.wordpress.com/2012/04/21/paul-krugman-steve-keen-and-the-mysticism-of-keynesian-economics/>) Pilkington blogs at <http://fixingtheeconomists.wordpress.com/>

Pilkington tells us that Keynes sorted all this out in Chapter 22 of the *General Theory* when he discussed the nature of the 'business cycle' and Pilkington concludes that of Keynes' explanations: "I think they hold up pretty well today". Pilkington says that Keynes makes clear what the "key determinate" of slumps in production and investment under capitalism: (Keynes quote): "The Trade Cycle is best regarded, I think, as being occasioned by a cyclical change in the marginal efficiency of capital, though complicated, and often aggravated by associated changes in the other significant short-period variables of the economic system."

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As Pilkington says, Keynes' category of the marginal efficiency of capital (MEC) is "*basically the expected profitability that investors think they will receive on their investments measured against the present cost of these investments*". Keynes' concept of MEC is his version of Marx's rate of profit. But it is different in some very important ways. First, Keynes is wedded to the neoclassical concept of marginalism. This is the idea, as things (supply or demand) grow, they rise, at the margin, at a slower rate; so there is a diminishing return on each new unit added. Marginalism is not justified in reality: indeed, there is plenty of evidence that there are economies of scale i.e. returns can increase not fall i.e. MEC can rise with expansion. But Keynes joins the neoclassicals in reckoning that, as capital gets larger, the MEC will fall. Indeed this is the basis of his view that capitalism will eventually move to some 'stationary state' of nirvana, leisure and prosperity. But that's another story.

The other aspect of Keynes' MEC is that his definition of capital is full of as many holes as Piketty's (see my post, <http://thenextrecession.wordpress.com/2014/04/15/thomas-piketty-and-the-search-for-r/> and others). Is capital just new investment of the stock of capital; is that investment just in tangible structures, equipment and technology, or does it include financial assets like bonds, stocks etc? It is not clear. Also, like all mainstream economics, capital

is a 'thing' for Keynes, namely it is either tangible equipment or claims of ownership on companies like stocks.

For Marx, capital is a social relation: it is about the way the ownership of things by capitalists enables them to exploit the labour power of those who own nothing but the ability to work. In practical economic terms, that means Marx's rate of profit includes the cost for capitalists in employing the workforce, as well as purchasing raw materials or factories. So you cannot work out what is happening to the rate of return on capital without including the value creating role of labour. Keynes and all mainstream economists since Smith and Ricardo carefully ignore the value of labour power in their definition of capital.

In doing so, we expose the real difference between Keynes explanation of crises and that of Marx – and which is closer to reality. What happens to cause a slump (recession or depression) in an economy, according to Keynes/Pilkington, is that there is "*a sudden collapse in the marginal efficiency of capital*". Pilkington is keen to show that, as against the more 'orthodox' Keynesians, the "*predominant explanation of the crisis is, not primarily a rise in the rate of interest*".

Pilkington expounds the thesis in relation to the US property slump in 2006-7 that triggered the Great Recession: "*Keynes would argue that the causal chain went as follows: interest rates began to rise => the MEC of investors began to fall => eventually the MEC reached a threshold point at which investors stopped building houses.*

A recession ensued". Who these 'investors' are that stopped building houses is not clear, but leave that aside. The question that flows from this 'causal chain' is: why did the MEC fall at some 'threshold point'? According to Pilkington/Keynes: "*The key component in the MEC is, of course, investor expectations. Keynes is clear on this and distinguishes himself from those who claim that a rise in the rate of interest is the cause of the crisis.*"

So there is a 'sudden collapse' in the MEC of 'investors' because they change their 'expectations' on the future return of their investments. The cause of crises is thus reduced to the unpredictable (and possibly irrational) psychology of capitalists (investors). This is a subjective, 'individual agency' theory of slumps. In contrast, Marx looks at the aggregate accumulation of value and surplus value by the capitalist economy and develops a law of profitability based on the exploitation of labour that explains objectively why capitalists 'suddenly' stop investing and a slump ensues.

Moreover, Marx's theory of crises can explain their regularity; Keynes/Pilkington's cannot. In the latter, slumps are unpredictable and cannot be regular because they depend on 'expectations'. Indeed, as Pilkington points out, Keynes denies that there is any 'business cycle' at all. And yet when Keynes wrote the *General Theory*, the evidence of cycles of boom and slump in capitalist economies had been well documented by the likes Wesley Mitchell, Burns and Schumpeter (see Jose A Tapia Granados entitled "Does investment call the tune? Empirical evidence and endogenous theories of the business cycle", to be found in Research in Political Economy, May 2012, http://sitemaker.umich.edu/tapia_granados/files/does_investment_call_the_tune_may_2012_forthcoming_rpe.pdf).

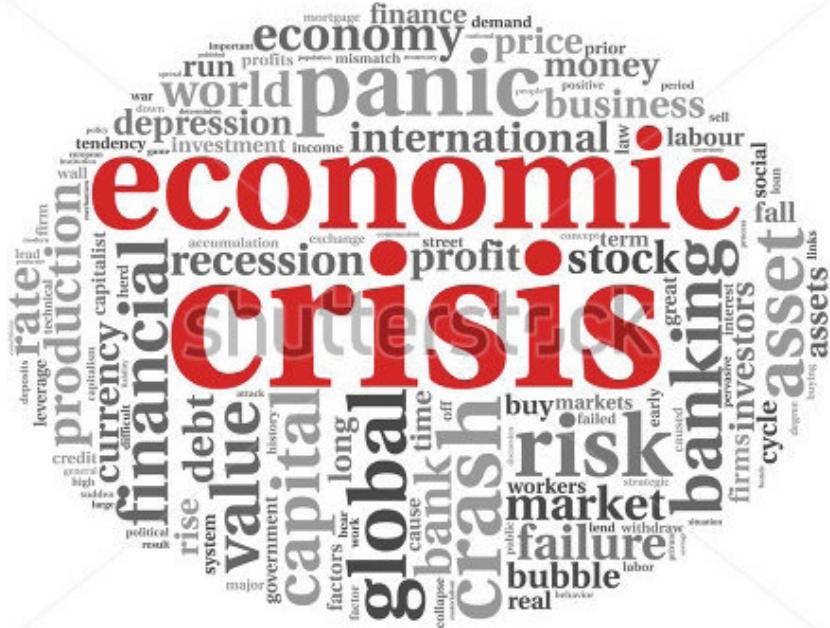
Anyway, with MEC as the cause of crises, Pilkington argues that the cure for crises follows. If the MEC falls 'suddenly', then the authorities must cut interest rates to the bone, below

the MEC, to restore investment and growth. The problem is that in a depression even that may not be enough and liquidity preference (the desire to hold cash) turns into a 'liquidity trap' that an economy cannot get out of even when interest rates are 'zero-bound' as they have been since 2008. So Pilkinson/Keynes says the authorities must resort to fiscal expansion to 'pump-prime' the economy i.e. increase government spending and/or cut taxes. Again to quote Keynes: "*the collapse in the marginal efficiency of capital may be so complete that no practicable reduction in the rate of interest will be enough*" especially "*as it is not so easy to revive the marginal efficiency of capital, determined, as it is, by the uncontrollable and disobedient psychology of the business world. It is the return of confidence, to speak in ordinary language, which is so insusceptible to control in an economy of individualistic capitalism.*"

So you see, crises are down to 'confidence' and 'business psychology' and we must turn these around for the better. Government spending and tax cuts for capitalist companies can do this. Thus the Keynesian answer is not to replace the failed capitalist sector with a planned economy owned in common (heaven forbid!), but to restore the 'confidence' of capitalists.

Now I and others have discussed in detail why fiscal spending, whether to raise consumption or boost investment, in a capitalist economy is no guarantee that it will recover (see my posts and papers, <http://thenextrecession.wordpress.com/2012/06/13/keynes-the-profits-equation-and-the-marxist-multiplier/>). The Keynesian multiplier won't work unless the profitability of capital rises (the Marxist multiplier). Indeed, increased government spending in a depression can lower profitability further and extend a slump. Even more important, Marx's law of profitability will eventually return and the boom will turn into another slump in due course.

Fiscal austerity will make the crisis worse or prolong it, according to Keynesians. This is the line of Simon Wren-Lewis, the arch Keynesian who blogs at <http://mainlymacro.blogspot.co.uk/>. In a recent post ("The entirely predictable recession"), he argues that the 'second Euro crisis' of 2010 onwards was caused by Euro governments trying to reduce government spending at a time when private investment had collapsed. Instead there was a need for 'countercyclical' fiscal stimulus to the economy. So the second recession was entirely predictable under Keynesian theory, he says.



Actually, just how much fiscal austerity was applied by Eurozone governments is a matter of debate, but what Wren-Lewis does not explain is: why the crisis started in the first place back in 2008 – a global crisis clearly nothing to do with fiscal policy and more to do with a collapse in capitalist sector investment. Why was that not predictable from Keynesian theory?

Anyway, Pilkington continues. Keynes' explanation of 'sudden' slumps provides a model for avoiding slumps, you see. *"Thus the remedy for the boom is not a higher rate of interest but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom."*

So we need to maintain very low rates of interest 'permanently' so that the MEC (hopefully) is always higher and an economic boom can go on forever. If this sometimes generates 'credit bubbles' and dangerous artificial booms in property or stock prices, then that is where we use fiscal policy and tax those bubbles away. As Pilkington concluded *"I think that this is overly simplistic but certainly on the right track....In this scheme the central bank controls overactive investment markets but does not really hold responsibility for ensuring that economic growth be maintained continuously. That is the role of fiscal policy."* By this judicious macroeconomic management, we can avoid crises forever!

Pilkington, however, is reluctant to allow the people and politicians to have a say in this brave new world of Keynesian policy. *"Personally I think that democracies are seriously flawed and politicians generally stupid and short-sighted. For this reason I would recommend building institutions that automatically open up the fiscal deficit"*. So fiscal action will become outside democratic control, just as finance capital has managed to get monetary policy out of democratic control with

'independent' central banks. The more you consider the Pilkington/Keynes causal chain of slump and the policy solutions of macroeconomic management divorced from democracy, the less it is convincing and the more it is distasteful. Keynes, the patrician, the Platonian philosopher king, knows best.

But would such macro-management of a capitalist economy work? Well, we have had the experience of such attempts in the post-war period when governments attempted to use fiscal policy 'countercyclically' to keep the economy on even keel. For a while, it seemed to work and in the Golden Age, investment and GDP growth was strong. But then it all went 'pear-shaped' in the 1970s, with the first simultaneous international slump in 1974-5 since the Great Depression and the emergence of 'stagflation' (low growth and high inflation) – the opposite of what Keynesian economics predicted. Why did this change take place?

Marxist theory explained it best. The Golden Age was nothing to do with successful Keynesian macromanagement and the subsequent crisis was nothing to do with it being dropped. It was down to the profitability of capital. This fell from the mid-1960s onwards through the 1970s and no matter how much fiscal management or interest rate juggling governments engaged in, governments could not avoid slumps and slower growth. It was not the 'psychology' of investors that changed the economy; it was the objective change in profitability that changed 'investor expectations'.

It also changed bourgeois economic theory. Keynesian economics gave way to monetarism and neoclassical equilibrium theory. The more radical aspects of Keynesian theory (uncertainty, irrational expectations, the marginal efficiency of capital) were dropped for more orthodox theories of supply and demand for money.

Simon Wren-Lewis, has been lamenting the failure to maintain Keynesian economics as providing the best

explanation of capitalist economies and the best prescription for avoiding slumps. In *Where macroeconomics went wrong*, he comments *"Why did we have a revolution which overturned an existing methodology and temporarily banished Keynesian theory... I would love to know the answer to these questions."*

I think the answer is obvious: the Keynesian approach in its most radical form ("the socialisation of investment") was unacceptable to the strategists of capital anyway; and even its more moderate approach was a failure in explaining the crises of the 1970s and 1980s. So mainstream economics returned to the theory of 'free markets' untouched by expensive government taxation and spending, and to a forthright attack on wages, regulations and employment. This was necessary to restore the profitability of capital. This became the neoclassical, neoliberal mainstream (for more on this, see the draft of an appendix on Keynesianism for my forthcoming book, *The Long Depression, appendix two*). Keynesian economics had no answer to ending crises while preserving capitalism, so it was dropped or merged into the mainstream. It still does not provide an explanation for the current slump and depression or a way out.