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A Tale of Two Letters

(Or How Twenty Economists and the Truth are a Majority)

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Is the status of UK debt destined to match that of Greece? That outcome turns on decisions yet to be taken. If the Treasury follows precepts outlined by signatories to a *Sunday Times* letter (14/02/2010; Exhibit 1), the liberal economic order is likely to hold.

Those outlined by signatories to a *Financial Times* letter (18/02/2010; Exhibit 2) are more likely to deliver a flight from sterling securities, a sharply depreciating exchange rate, high inflation and calls to impose foreign exchange controls, incomes policy and other illiberal measures.

A brief appraisal of the background of (many of the) signatories would have signaled as much. The primary signatory leading those arguing for greater fiscal laxity is Lord Skidelsky who, although an economist neither by training nor disposition (see http://www.skidelskyr.com/site/view/biography/) is justifiably respected as Keynes's biographer. Less acceptable is Skedelsky's inability to accept that ignorance should temper strong opinions (see Exhibit 5).

Skidelsky is an associate of many among the *Financial Times* signatories who trade under the banner 'post-Keynesian economics.' (see Exhibit 6). As a short-hand descriptor, post-Keynesians are reasonably regarded as 'neo-Marxists'. Noteworthy within the *Financial Times* statement is the utter nonsense of the personification of 'financial markets':

> 'In urging a faster pace of deficit reduction to reassure the financial markets, the signatories of the *Sunday Times* letter implicitly accept as binding the views of the same financial markets whose mistakes precipitated the crisis in the first place!'

This is nothing new: it is a regular feature for socialists to blame 'financial markets'. Most graphically, Harold Wilson blamed the 'Gnomes of Zurich' for the forced sterling devaluation of 1967.

Financial markets are where free men and women and those who act as agents for free men and women - entrepreneurs, bankers, pension fund managers and finance ministers - conduct (part of) their business. Yet, that world of finance - in all of its aspects - is an anathema to post-Keynesian economists.

Financial market traders guard as best they can against debtors who renege on their obligations. When sterling falls in value, holders of sterling assets take a real capital loss. One among the *Financial Times* signatories argues for the opportunity to be taken: David Blanchflower (Radio 4 *The Today Programme*) would raise the UK inflation target to four percent, thereby to reduce the real UK debt burden. That is a morally bankrupt proposal; and one that would cause UK debt to be swiftly downgraded (by those wicked financial markets). All-in-all a very bad idea, although consistent with the tenor of Exhibit 2. With a 'negative' credit rating outlook (Fitch), the UK's triple-A debt status is 'ours to lose' (Mervyn King). Exhibit 2 explains exactly how it could be lost.

Exhibit 1:

letter to *The Sunday Times* February 14, 2010
(http://www.timesonline.co.uk/tol/comment/letters/article7026234.ece)

UK economy cries out for credible rescue plan

IT IS now clear that the UK economy entered the recession with a large structural budget deficit. As a result the UK's budget deficit is now the largest in our peacetime history and among the largest in the developed world.

In these circumstances a credible medium-term fiscal consolidation plan would make a sustainable recovery more likely.

In the absence of a credible plan, there is a risk that a loss of confidence in the UK's economic policy framework will contribute to higher long-term interest rates and/or currency instability, which could undermine the recovery.

In order to minimise this risk and support a sustainable recovery, the next government should set out a detailed plan to reduce the structural budget deficit more quickly than set out in the 2009 pre-budget report.

The exact timing of measures should be sensitive to developments in the economy, particularly the fragility of the recovery. However, in order to be credible, the government's goal should be to eliminate the structural current budget deficit over the course of a parliament, and there is a compelling case, all else being equal, for the first measures beginning to take effect in the 2010-11 fiscal year.

The bulk of this fiscal consolidation should be borne by reductions in government spending, but that process should be mindful of its impact on society's more vulnerable groups. Tax increases should be broad-based and minimise damaging increases in marginal tax rates on employment and investment.

In order to restore trust in the fiscal framework, the government should also introduce more independence into the generation of fiscal forecasts and the scrutiny of the government's performance against its stated fiscal goals.

1. Tim Besley, London School of Economics;
2. Sir Howard Davies, London School of Economics;
3. Charles Goodhart, London School of Economics;
4. Albert Marcet, London School of Economics;
5. Christopher Pissarides, London School of Economics;
6. Danny Quah, London School of Economics;
7. Meghnad Desai London School of Economics;
8. Andrew Turnbull, London School of Economics;
9. Orazio Attanasio, University College London
10. Costas Meghir, University College London;
11. Sir John Vickers, Oxford University;
12. John Muellbauer, Nuffield College, Oxford;
13. David Newbery, Cambridge University;
14. Hashem Pesaran, Cambridge University;
15. Ken Rogoff, Harvard University;
16. Thomas Sargent, New York University;
17. Anne Sibert, Birkbeck College, University of London;
18. Michael Wickens, University of York and Cardiff Business School;
19. Roger Bootle, Capital Economics;
20. Bridget Rosewell, GLA and Volterra Consulting

Exhibit 2:

letter to *The Financial Times* February 18 2010
(http://www.ft.com/cms/s/0/84b12d80-1cdd-11df-8d8e-00144feab49a.html)

First priority must be to restore robust growth

From Lord Skidelsky and others.

Sir, In their letter to The Sunday Times of February 14, Professor Tim Besley and 19 co-signatories called for an accelerated programme of fiscal consolidation. We believe they are wrong.

They argue that the UK entered the recession with a large structural deficit and that "as a result the UK's deficit is now the largest in our peacetime history". What they fail to point out is that the current deficit reflects the deepest and longest global recession since the war, with extraordinary public sector fiscal and financial support needed to prevent the UK economy falling off a cliff. They omit to say that the contraction in UK output since September 2008 has been more than 6 per cent, that unemployment has risen by almost 2 percentage points and that the economy is not yet on a secure recovery path.

There is no disagreement that fiscal consolidation will be necessary to put UK public finances back on a sustainable basis. But the timing of the measures should depend on the strength of the recovery. The Treasury has committed itself to more than halving the budget deficit by 2013-14, with most of the consolidation taking place when recovery is firmly established. In urging a faster pace of deficit reduction to reassure the financial markets, the signatories of the *Sunday Times* letter implicitly accept as binding the views of the same financial markets whose mistakes precipitated the crisis in the first place!

They seek to frighten us with the present level of the deficit but mention neither the automatic reduction that will be achieved as and when growth is resumed nor the effects of growth on investor confidence. How do the letter's signatories imagine foreign creditors will react if implementing fierce spending cuts tips the economy back into recession? To ask – as they do – for independent appraisal of fiscal policy forecasts is sensible. But for the good of the British people – and for fiscal sustainability – the first priority must be to restore robust economic growth. The wealth of the nation lies in what its citizens can produce.

1. Lord Skidelsky, University of Warwick, UK
2. Marcus Miller, University of Warwick, UK
3. David Blanchflower, Dartmouth College, US and University of Stirling, UK
4. Kern Alexander, University of Zurich, Switzerland
5. Martyn Andrews, University of Manchester, UK
6. David Bell, University of Stirling, UK
7. William Brown, University of Cambridge, UK
8. Mustafa Caglayan, University of Sheffield, UK
9. Victoria Chick, University College London, UK
10. Christopher Cramer, SOAS, London, UK
11. Paul De Grauwe, K. U. Leuven, Belgium
12. Brad DeLong, U.C. Berkeley, US
13. Marina Della Giusta, University of Reading, UK
14. Andy Dickerson, University of Sheffield, UK
15. John Driffill, Birkbeck College London, UK
16. Ciaran Driver, Imperial College London, UK
17. Sheila Dow, University of Stirling, UK
18. Chris Edwards, University of East Anglia, UK
19. Peter Elias, University of Warwick, UK
20. Bob Elliot, University of Aberdeen, UK
21. Jean-Paul Fitoussi, Sciences-po, Paris, France

22. Giuseppe Fontana, University of Leeds, UK
23. Richard Freeman, Harvard University, US
24. Francis Green, , University of Kent, UK
25. G.C. Harcourt, University of Cambridge and University of Adelaide, Australia
26. Peter Hammond, University of Warwick, UK
27. Mark Hayes,University of Cambridge, UK
28. David Held, LSE, UK
29. Jerome de Henau, Open University, UK
30. Susan Himmelweit, Open University, UK
31. Geoffrey Hodgson, University of Hertfordshire, UK
32. Jane Humphries, University of Oxford, UK
33. Grazia Ietto-Gillies, London South Bank University, UK
34. George Irvin, SOAS London, UK
35. Geraint Johnes, Lancaster University, UK
36. Mary Kaldor, LSE, UK
37. Alan Kirman, Ecole des Hautes Etudes en Sciences Sociales, Institut Universitaire de France
38. Dennis Leech, Warwick University, UK
39. Robert MacCulloch, Imperial College London, UK
40. Stephen Machin, University College London, UK
41. George Magnus, UBS Investment Bank
42. Alan Manning, LSE, UK
43. Ron Martin, University of Cambridge, UK
44. Simon Mohun, QML, UK
45. Phil Murphy, University of Swansea, UK
46. Robin Naylor, University of Warwick, UK
47. Alberto Paloni, University of Glasgow, UK
48. Rick van der Ploeg, University of Oxford, UK
49. Lord Peston, QML, London, UK
50. Robert Rowthorn, University of Cambridge, UK
51. Malcolm Sawyer, University of Leeds, UK
52. Richard Smith, University of Cambridge, UK
53. Frances Stewart, University of Oxford, UK
54. Joseph Stiglitz, Columbia University, US
55. Andrew Trigg, Open University, UK
56. John Van Reenen, LSE, UK
57. Roberto Veneziani, QML, UK
58. John Weeks, SOAS, London, UK

Exhibit 3:

letter to *The Financial Times* 25 January 25 2010
(http://www.ft.com/cms/s/0/096eb5a0-0952-11df-ba88-00144feabdc0.html)

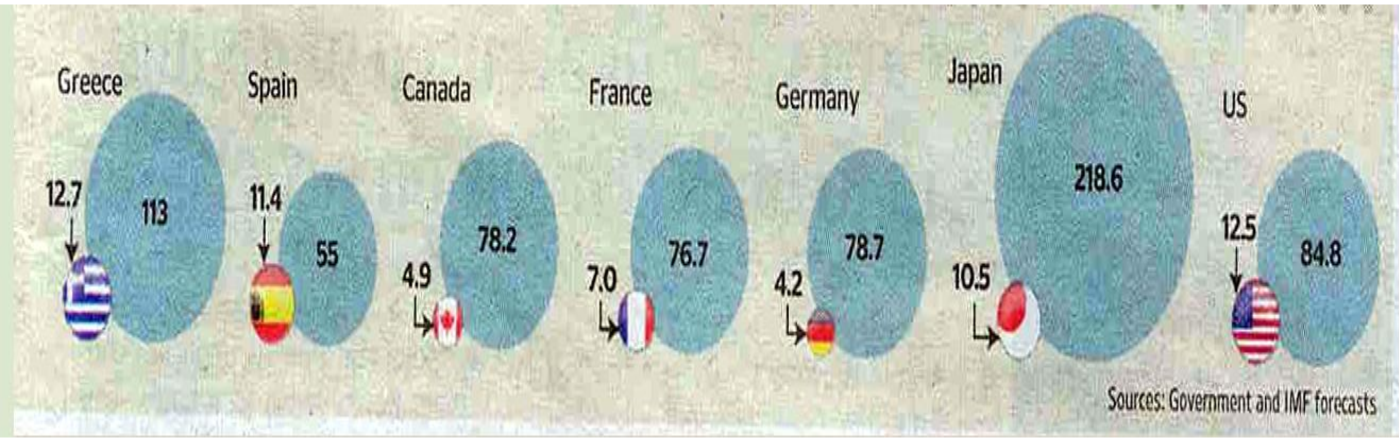
Does China want more US paper?

Sir, Offset China's saving with more UK/US debt? More bond-financed fiscal deficit spending until inflation outweighs the gains to domestic employment? ("The Great Piggy Bank of China"*, Samuel Brittan, January 22.) Why should China be interested in amassing still more US paper? Recommendations of this ilk rest on Keynes's assertion that high unemployment and high inflation cannot co-exist. Almost certainly, it is too late, but slashing western deficits is the one option to avert a repetition of 1970s stagflation.

G.R. Steele, Lancaster University

*http://www.ft.com/cms/s/0/026f5ae0-06cb-11df-b058-00144feabdc0,dwp_uuid=9c33700c-4c86-11da-89df-0000779e2340.html

Exhibit 4:
***The Times* 19 February 2010**
Red alert in the markets as debts rise in Treasury's 'bumper' month
(http://business.timesonline.co.uk/tol/business/markets/article7032870.ece)



Fiscal Deficits and Sovereign Debt

Exhibit 5: Lord Skidelsky

Comment upon
Skidelsky, R. (2006) 'Hayek versus Keynes'
in Feser, E. (2006) *Cambridge Companion to Hayek*

1. Skidelsky writes that Hayek's

> 'story presupposes that changes in money work themselves slowly and unevenly through the prices system. But this is inconsistent with his assumption of perfect foresight'.

Comment
While it is true that Hayek's earliest contribution to monetary theory - *Intertemporal Price Equilibrium and Movements in the Value of Money* (1928) - invokes perfect foresight, it is important to understand its *extent*. Agents are assumed to anticipate events accurately *so long as money is neutral*; but when money is non-neutral, 'influences which are wholly unrelated to the basic impulses of the economy' disrupt price-adjustments, transactions, patterns of saving, investment and production. Hayek's invocation of perfect foresight is very tightly focused. He was fully aware that assumption of perfect foresight would not serve any comprehensive social theory. There is no other context in which Hayek invokes the 'assumption of perfect foresight'. (Roger Backhouse's paper in Feser's collection is consistent with these comments.)

2. Skidelsky writes that Keynes distanced his economics

> 'from the timeless simultaneous general equilibrium theory of Menger and Walras which Hayek regarded as the supreme achievement of the marginalist revolution'

Comment
Hayek made no such endorsement and distanced himself from that paradigm. (Meghnad Desai's paper in Feser's collection gives emphasis to this point.)

3. Skidelsky writes - in relation to 'Economics and knowledge' - that

> 'Hayek redefined equilibrium as a situation in which there exists a mutual coordination of plans. But, given its impossible knowledge requirements, it became a purely fictional construction, of no predictive value'

Comment
On the contrary, Hayek's *does* show that the 'knowledge requirements' are entirely practical. He explains this, for example, in 'The Use of Knowledge in Society' (1945), where he writes that, although no single person oversees the whole field, the

> 'limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all' (Hayek, 1945).

4. Skidelsky writes that Hayek provides

> 'no explanation of why a change in the quantity of money should have any effect on the structure of production at all'

Comment
On the contrary, Hayek *does* show how a change in the quantity of money (*via*, an 'interest rate effect' and a 'relative price effect') alters the structure of production. In the context of the early 1930s, Sraffa's criticism may have been 'crushing', given the then current state of Hayek's theory (of business fluctuations). However, with Hayek's refinement of that theory through to 1941 (*The*

Pure Theory of Capital), Skidelsky's comment - 'Few rejoinders show up more crushingly the limitations of Hayek's analysis' - is misleading. In its final form, Hayek's analysis is sound; which is the reason - as Skidelsky rightly states - that 'Hayek never renounced his early cycle theory'. (Meghnad Desai's paper in Feser's collection makes this point.)

5. Skidelsky writes:

> '[Keynes's] training in economics was so superficial'
> 'Keynes was a better economist, which is why Hayek eventually abandoned economics for political philosophy'

Comment
Skidelsky surely did not intend to suggest that Hayek moved away from economics because Keynes was a better economist! (Skidelsky does not say whose view it was that 'Keynes was a better economist'.) Although Hayek had great respect for Keynes the man, he had none for Keynes as economist:

> 'before he started to develop his own theories, Keynes was not a highly trained or a very sophisticated economic theorist' (Hayek, 1978);
> 'Widely read as Keynes was in many fields, his education in economics was somewhat narrow' (Hayek, 1972);
> 'I don't think he spent more than a year learning economics' (Hayek, 1994).

Furthermore, Hayek did not abandon economics. He took a break! While Hayek's motives are disputed, no one suggests the reason Skidelsky gives. Hayek wrote on monetary theory and against Keynesian economics late into his life.

6. Skidelsky writes:

> 'Keynes eventually found a way of shaping his intuitions into a logically consistent model'

Comment
This - the neo-classical synthesis - was John Hicks's achievement; and one that Joan Robinson and others of the Cambridge Circus deplored. Had Keynes shaped *The General Theory* as a logically coherent whole, the long-drawn exegesis of *The General Theory* would not have been necessary.

7. Skidelsky writes:

> 'Hayek enthusiastically endorsed … [post-war credits] … without pointing out that the calculation of how "much" money to take out of the economy was highly dependent on putting numbers to the aggregative analysis of the *General Theory*, one which Hayek repudiated on methodological grounds'

Comment
This is wrong: the alternative (long-standing) basis for 'the calculation of how "much" money to take out of the economy' is the Quantity theory of money. On this, Hayek's view is known:

> 'I am even ready to concede that so far as it goes it is true, and that, from a practical point of view, it would be one of the worst things which would befall us if the general public should ever again cease to believe the elementary propositions of the Quantity Theory' (Hayek, 1935)

Exhibit 6: Post-Keynesians

Extracts from Steele, G.R. (2001): *Keynes and Hayek: the Money Economy*, chapter 9, 'Austrians and post-Keynesians'

Robert Solow is not alone in noting that post-Keynesians are united more by their distastes than by their affinities:

> 'I don't see an intellectual connection ... except that they are all against the same thing, namely against the mainstream, whatever that is. ... It seems to be mostly a community which knows what it is against but doesn't offer anything very systematic that could be described as a positive theory.' (Robert Solow: Klamer, 1984, p. 183)

In their general view of the modern capitalist monetary economy, post-Keynesian dislike much of what they see. The origin of post-Keynesian economics is Cambridge, England in the 1950s: with Joan Robinson, Richard Kahn, Nicholas Kaldor and Piero Sraffa. Its inception was a reaction to neoclassical microeconomics and ISLM macroeconomics.

When many post-Keynesians target neoclassical economics they presume to target the market system. This is curious: neoclassical economics is not concerned with markets. The neoclassical method of marginal analysis identifies the characteristics of an economically efficient outcome; it says nothing about how that outcome might be achieved. Although different sets of assumptions are categorised as competitive, monopolistic, and oligopolistic, close inspection reveals that no one is competing. The entrepreneurial function is either about to commence (disequilibrium) or completed (equilibrium). Entrepreneurial battle-plans for logistics, reconnaissance, communication and deployment are strangely absent.

Post-Keynesians emphasise the organic structure of an economic system whose parameters constrain individual action. Since post-Keynesians argue that those societal parameters can be changed through the exercise of a *political* will, the debate turns on the manner in which an individual may affect the destiny of himself and others. Where Austrian economics is grounded in the philosophy of classical liberalism, the orientation of post-Keynesianism is constructive rationalism. Where Austrians emphasise the capacity of individuals' actions to change the course of events, post-Keynesians emphasise the structural parameters that constrain and direct individuals' actions.

The priority of post-Keynesians is employment creation. This is afforded such weight that wealth creation and want satisfaction are of peripheral and even dubious merit: wants are too easily manipulated by marketing media that are in the hands of those in privileged positions of power. The post-Keynesian agenda - for constructivist rational societal change - is founded upon a conception of a social structure that is much more than a set of abstract and impartial rules. To post-Keynesians, the impartiality of such rules is suspect: they are tied to a particular power structure and set of interests.

The familiar post-Keynesian conclusion is that, if policy were directed by those who remain true to the fundamentals of *The General Theory* (and begging the question of the political regimen that is most likely to achieve that end), those saviours would be equipped to deliver full employment (firstly), an equitable distribution of wealth (secondly) and the consequences thereof (only distantly):

> '[a]re we not told that 'since in the long run we are all dead', policy should be guided entirely by short-run considerations? I fear that these believers in the principle of *après nous le déluge* may get what they have bargained for sooner than they wish.' (Hayek, 1941, p. 410)