Coping with Reality

Keynes Versus Mainstream Textbooks in Economics

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Abstract

Abstract: *Despite the fact that The General Theory of Theory of Interest, Employment and Income (**GT**) is a highly theoretical work, Keynes tries to make his theory as **realistic** as possible. In this paper it is analyzed how. This is done by identifying selected quotations in which Keynes either explicitly refers to the actually existing economy or comments upon or relates to the question of theorizing versus reality. By analyzing (or generalizing) this empirical material it is demonstrated that Keynes copes with reality by generalizing from experience, giving priority to the most important parts of economic reality and by making empirically based assumptions rather than assumptions consistent to a theoretical model. If economic textbooks were to apply the same stringent principles not much would be left…*

> 'Our criticism of the accepted classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied, with the result that it cannot solve the problems of the actual world' (Keynes, 1936, p. 378).

> "It may well be that the classical theory represents the way in which we should like our economy to behave. But to assume that it actually does so is to assume our difficulties away" (op.cit., p. 34).

Much has been written on the method applied by John Maynard Keynes. In this article one specific issue but of overarching importance will be discussed. *How does Keynes cope with the actually existing reality in his seminal work General Theory (GT)?* This might sound esoteric but it is a key issue in economics as some economists like the present author would argue that large chunks of economic theory is to quote 'simply made…up' (Bergman, 2005, p. 56) - that is developed on a deductive basis with an unclear or non-existing relation to economic behaviour in real life. To the present author this raises the question: is Keynes any better? How does his theory relate to reality? Could we possibly learn anything from the way he 'copes with reality'? In the following the focus will be on this specific question but as such it also relates to the whole industry that discusses the more general method(s) applied by Keynes as in the classic work by Kregel (1976).

All through the text we shall compare his approach with how it is done in an idealtype mainstream textbook (sometimes represented by an actual textbook for the purpose of illustration - the new Keynesian textbook made by Lipsey and Chrystal, 2007). In this context the textbook represents a mainstream attempt to cope with reality. Hence, this comparison works as a prism highlighting the qualities of the contribution made by Keynes in this respect. Without entering into this discussion it is implicitly assumed that most problems of coping with reality in textbooks are reproduced in much of the economic research with some notable exceptions.

In what follows the question of theory (model) versus reality in economics is firstly briefly introduced, but the main bulk of the article analyzes the way Keynes copes with reality in GT in some detail. Finally, some concluding thoughts are presented.

1. Briefly on theory versus reality in economic textbooks

Economic textbooks (as well as textbooks of other disciplines) represent a more or less general consensus on what constitutes the core of the trade. The most well-known theories (often called 'models' by economists) are presented here. It is implicitly assumed that these theories somehow relate to reality but in textbooks as well as in most research this issue is never discussed in depth. It might be mentioned in passing that e.g. the perfect markets are not easily if at all found in reality (e.g. Lipsey and Chrystal, 2007, p. 181) but it is not really discussed why a theory of a market that does tend not to exist takes up so much space or of which use such a theory is.[1] One could argue that textbooks deliver the theories and then it is up to the reader to relate them to reality. Problems of operationalization are not really discussed in textbooks.

Furthermore, the standard textbook starts by introducing simple models and gradually more complicated models are introduced. Hereby, the reader is given the impression that the more models and the more complications, the better the grasp of reality. By this gradual process theory is implicitly depictured as getting ever closer to actually dealing with the real complexities of reality. Economics appears to be a science that is progressing gradually by ever constant attempts to refine and improve its representations (theories and models) of reality. According to the underlying logic of this only slightly caricaturized picture, the relation between theory and reality has been settled once and for all. Generally, it is - again implicitly - assumed that we know how the economy works and this is what is described by theory. Now and then reality – that is histories from the real world - enters the picture by illustrating some of the theoretical arguments made but basically theory and reality do have a very limited mutual impact on each other.[2]

[1] Some would argue that it is useless. It might not be – it might be used as an illustration of how economists think or as a benchmark but figuring this out is essentially left to the imagination of the reader. The point we would like to emphasise is, however, that perfect markets are taken for granted.

[2] In Lipsey and Chrystal (2007) one can find a very interesting and exceptional example of at least partial adaptation of theory to actual reality. For years the application of the ISLM model in textbooks led to the following interpretation of actual monetary policy: the interest rate is changed by changing the amount of money supplied. In the 2007 version it is explicitly acknowledged that monetary policy is conducted by setting the short interesting rate while the money demand and supply adapt to changes in the interest rate. In this way the money supply has become partly endogenized – as suggested by post-Keynesians for decades. Only partly as this adaption has not been quite digested by the textbook authors; it is, hence, still assumed that

But what happens to textbooks and economic theory when the (economic) world changes dramatically as during the financial crisis? Basically, nothing – as economic textbooks are supposed to tell us about the everlasting underlying forces of any capitalist economy. A financial crisis is something happening on the surface of the economy – without questioning the basic underlying mechanisms of supply and demand, equilibrium and rationality etc. This interpretation contributes to explaining why e.g. some Danish economists have argued that the economic curriculum essentially remains the same – crisis or no crisis.[3]

What would Keynes have done in a similar situation facing a long downturn of the global economy? As GT was a theoretical response to the crisis in the thirties the answer is rather obvious. Keynes would have suggested that theory would have to be open and sufficiently flexible to take account for a reality which changes on a current basis. Henceforth, we need to change and adapt the way we analyze reality on a current basis too. In contrast textbook economics has an arms length approach to reality – as a logical consequence of the underlying notions of rationality and equilibrium - which have more to do with abstract deductive theorizing than actual reality.

2. How does Keynes relate to reality in General Theory?

In contrast to textbooks in GT we witness a theory in the making. GT is an open laboratory in which Keynes tries in an open discussion to organize his thoughts on economic issues he considers as being of importance. In doing this he relates to the theoretical state of art of his day (now called prekeynesian theory or neoclassical theory) and the empirical reality of yesterday and the problems of (his) today and he attempts to relate this knowledge (old theory and old and new reality) to his new way of thinking. He persistently tries to make his argument consistent. At the same time he repeatedly points to the limits to his arguments. In this sense GT is an open and very transparent on-going discussion.

But this is a very general picture. When reading GT the first and dominant impression is the *absence* of reality. It is *really* a highly theoretical work or as Keynes puts it:"its [GT] main purpose is to deal with questions of theory, and only in the second place with the applications of this theory to practice" (p. xxi). As a consequence one finds very few references or indications of a reality outside the theory presented in the book. Basically, Keynes is concerned with constructing a model rather than applying or relating it to

when prices increase the real money supply will decrease accordingly (rather than letting the money supply expand endogenously and hereby automatically satisfying the increased demand for money due to the higher prices).

[3] The financial crisis is expected to be gradually incorporated in economic textbooks but 'there is no need for throwing out the current theoretical foundation'. 'Economics will survice the financial crisis', DJØF-magazine, no. 3, 13.2.2009.

the real world. For this reason one has to analyze GT in order to identify the reality. But it is there – between the lines, in passing and in some few instances reality is explicitly mentioned and used as a platform for theorizing.

By analyzing GT one can, hence, identify a number of causalities and distinct features of how capitalism works in 1936 which Keynes regards to be of general importance. Nine of these stylized facts are presented in the following and several of them are well-known. Most of these relates to typical capitalist and industrialized countries while some of them mainly relate to the dominant economy USA. The nine points are structured according to page number rather than importance. (Please observe that when Keynes talks about reality he often uses the word 'fact(s)').

1. "there will always exist in a non-static society a proportion of resources unemployed 'between jobs'" (p.6). In other words search unemployment is an empirical fact.

2. In general he relates to the working of the *actual* labour market rather than labour markets characterized by perfect competition, which tend to dominate modern days textbooks:

   > 'in view of the fact that the population generally is seldom doing as much work as it would like to do...' (p.7) 'relates to the actual attitude of workers towards real wages…' (p.8). "Whilst workers will usually resist a reduction of money wages…the contention that the unemployment which characterises a depression is due to a refusal by labour to accept a reduction of money-wages is not clearly supported by the facts…" (p.9).

   In other words: some degree of involuntary unemployment is the rule rather than the exception in any capitalist economy and workers will tend to resist reductions in money wages but this lack of flexibility in nominal wages does not – as assumed by textbooks – explain the existence of unemployment as this is not 'clearly supported by *the facts*'.

3. Keynes states the following about the concept of effective demand:

   > "For professional economists, after Malthus, were apparently unmoved by the lack of correspondence between the results of their theory and the facts of observation;-a discrepancy which ordinary man has not failed to observe, with the result of his growing unwillingness to accord to economists that measure of respect which he gives to other groups of scientists whose theo-

> retical results are confirmed by observation when they are applied to the facts… having left this world for the cultivation of their gardens ” (p. 33).

The concept of effective demand is hence also based on ‘facts of observation’ – it is actually in some sense out there.

4. Consumption is assumed to grow less than income as this is an ‘actual fact’ (p. 118).

5. “The *state of confidence*, as they term it, is a matter to which practical men always pay the closest and most anxious attention” (p. 148). In other words this key concept in GT is out there and makes sense to businessmen.

6. “With the separation between ownership and management which prevails to-day and with the development of organised investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system” (p.150-51).

   Again Keynes relates to a real life phenomenon which does play a crucial role in explaining the working of any capitalist system.

7. “When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done” (p.159 – referring to the USA). This well known quotation does, hence, also relate to parts of empirical reality.

8. One of Keynes’es greatest achievements was to change the understanding of the interest rate as being something natural or even physical. Again he did so by actually observing how the interest rate behaves in real life. He did observe two related ‘facts’: that a lot of psychology is involved in determining how the interest rate behave and that one cannot rely on the interest rate in establishing equilibrium:

   > “the rate of interest is a highly psychological phenomenon” (p. 202)… There are, however, several reasons, which taken in combination are of a compelling force, why in an economy of the type which we are accustomed it is very probable that the money-rate of interest will often prove reluctant to decline adequately” (p. 232).

9. In the following quotation he gives an overall view of his analysis of the general working of the actually existing economic system:

> "But the actual phenomena of the economic system are also coloured by certain special characteristics of the propensity to consume, the schedule of the marginal efficiency of capital and the rate of interest, about which we can safely generalise from experience, but which are not logically necessary. In particular, it is an outstanding characteristic of the economic system in which we live that, whilst it is subject to severe fluctuations in respect of output and employment, it is not violently unstable. Indeed it seems capable of remaining in a chronic condition of sub-normal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse. Moreover, the evidence indicates that full, or even approximately full, employment is of rare and even short-lived occurrence…an intermediate situation which is neither desperate nor satisfactory is our normal lot…useful to consider what hypothetical psychological propensities would lead to a stable system" (p. 250).

A number of important observations are made in this quotation. He characterizes his method in general terms: he 'generalize(s) from experience'. In other words Keynes applies a qualitative method in the sense that he tries to identify the dominant qualities or the general patterns of then phenomenon under study – in this case the actually existing capitalistic societies.

Secondly, he mentions one of the most basic features of the capitalist system as we know it: it is unstable but not violently so. Thirdly, he observes – once again - that full employment is an exception rather than the rule. In contrast in textbooks the economic system is assumed to - in the long run – to end up in a situation characterized by full employment. Full employment in textbooks is in this sense the rule rather than the exception. This is, however, an assumption or logical consequence of the construction of the theory – not something that follows from actually observing economic systems in 'the long run'. Fourthly, Keynes also indicates that it does make sense to think about hypothetical 'propensities' – that is imagining how the economic system would have to be changed in order to produce full employment. And the underlying message is that this will not happen automatically by relying on market forces only.

Hence, Keynes was of the opinion that it is possible to say something general about the actually existing capitalism and that is possible to take reality as a point of departure without drowning in a complex reality.[4] Keynes copes with complexity by giving priority to the most important parts of reality, cf.: “This is not a complete catalogue of all the possible reactions of wage reductions *in the complex real world*. But the above cover, those which are usually the most important” (p.264, my emphasis).

As for the making of assumptions – a necessary part of any economist’s tool box – Keynes demonstrates a preference for making what he calls: “plausible assumptions relating to the real world” (p.306). This is a rather radical preference. Economists often make assumptions in order to make their models consistent but these assumptions are not necessarily backed by empirical evidence – consistence counts more that reality. However, according to Keynes assumptions as well as causalities have to be backed by empirical evidence.

By identifying the main characteristics and the most important causalities of the actually existing economic system and by making plausible assumptions Keynes is capable of ‘taming’ the real world (se also Kregel, 1976, p. 211). Of course Keynes acknowledges that reality in itself is too complex to grasp without generalizing and making plausible assumptions.

One of the main problems of textbooks of economic is that all causalities and assumptions are presented on equal footing – none are presented as more well-founded or more important than others. Keynes on the other hand on a current basis discusses which causalities and assumptions are plausible (and why) and he is very careful in indicating when he makes some temporary assumptions for the sake of the argument.

3. What can we learn from Keynes concerning the coping with reality?

We have already learned a lot from Keynes despite the regrettable fact that so much has been forgotten in mainstream textbooks. But we can also learn something to which less attention has been paid. Without formulating it explicitly in his writing Keynes demonstrates a deep awareness of the subtle problems of how to analyse the actually existing economies – also known as the model/theory versus reality problem.

The message above could be condensed into three points. When making or creating economic theory we should:

a. generalize from experience
b. give priority to the most important parts of reality
c. make assumptions that are based in how the real world actually works.

[4] Bergman (2005) formulates the fear of drowning in this way: “Most economists apparently fear that the abandonment of the nonobservational method, and a plunge into research on the messy and multitudinous world of business behavior, might well leave us with just the latter” (p. 57).

This might sound all too obvious and non-economists would probably suppose (or hope) that this is what economists are already doing. We would, however, argue that most economic research and any mainstream textbook in economics would not pass this test. Large parts of textbooks consist of theory not being ‘generalized from experience’, whole sections having nothing to do with reality (e.g. competitive markets) and assumptions are just made time and again without any empirical backing (firms maximize profits; agents are supposed to be rational, the economy is moving towards equilibrium, the long run is something actually existing etc….).

Keynes does also send another message from his grave of a more ‘meta-like’ character – related to the theory-reality discussion. Present day textbooks are rather authoritarian due to the content, structure and tone: ‘Now we are going to tell you how the economy really works’. Keynes prefers to take a more open discussion being quite frank about complications, unrealistic assumptions for the sake of the argument etc. He enters into a democratic dialogue on an almost even footing with the reader – without undermining his indisputable authority.

An even more general message we can learn from Keynes is that we cannot just apply theory already developed without any adjustments to the field under study. We have to let the chosen theoretical framework interact with the piece of reality which we want to analyze and adjust theory accordingly. Henceforth, theorizing and doing the empirical investigation are two sides of the same coin. As a consequence we also need to be much more disrespectful towards theory than economists usually are. If we were to take this message seriously it would lead to a very critical reading and revision of the textbooks on the market. Not much would survive such a reading. Financial crisis or no crisis.

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