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# UNIVERSITÀ DEGLI STUDI DI TORINO

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The crisis in macro and the limitations of the economics of Keynes. Or why the Master will not return unless his General Theory is dressed up in neo-modern clothes

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*The crisis in macro and the limitations of the  
economics of Keynes.  
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Theory is dressed up in neomodern clothes*

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## **Abstract**

This paper argues that the *General Theory* will come back into fashion only if it is substantially amended. Following the classification of economic theories in terms of the modernist/postmodernist distinction first suggested by Phelps, this paper holds that Keynes's limitations are due to the fact that he remains confined within a modernist approach to economics that is for many reasons inadequate. As shown, for example, by his suggestion that economists should be like dentists, he is committed to a static approach, placing the emphasis on the anatomy of capitalism rather than 'interactionist' properties, such as those reflecting the interplay between agents and policymakers. Such properties, which are emphasized in postmodern literature, are crucial for the improvement of macro theories. Thus the paper argues that the time is ripe for a 'neomodern' synthesis that seeks to combine Keynes's basic ideas with those new insights.

## **Introduction**

This paper addresses the crisis in macro and the possibility that this could lead to a revival of the *General Theory*, both in teaching and policy advice, as explicitly advocated by many recent books (see for example, Lance Taylor's *Maynard's Revenge*, Robert Skidelsky's *Keynes: The Return of the Master* or Paul Davidson's *The Keynes Solution*).

In my view, this event is unlikely to happen. The *General Theory* will not come back into fashion without substantial amendment. Like it or not, even in the face of a deep crisis such as the present one, most economists simply regard Keynesian economics either as the source of some *ad hoc* or last resort policy remedies devoid of intellectual appeal (such as the need to fix the economy by running budget deficits) or, from the theoretical point of view, as synonymous with a vast array of 'sub-optimal results' caused by market imperfections which often turn out to be little more than sophisticated versions of pre-Keynesian stories.

I suggest that to become really fashionable again –in both policy and theoretical terms, in such a way as to inspire new research programmes – those believing in the potential of 'Keynesian theory in the spirit of Keynes' should not just rely on the (necessary) critique of standard theories but also come to terms with some key defects in both the *General Theory* and in post-Keynesian approaches.

In order to understand the limitations of the *General Theory* (as well as its actual achievements) better, it is useful to adopt an evolutionary view of theories and place this book in its historical and cultural context, rather than to consider it as a stand-alone product. Using the modernist/postmodernist labels proposed by Phelps in his book on schools of thought (see Phelps 1990, Dow 1991), Keynes can be regarded as belonging to the stage of 'high modernism' in economic theory, in line with other key contemporary revolutionary thinkers, such as Picasso or Einstein (for a similar view, see Klaes 2006). To avoid misunderstanding, it should be clear that economic theories or paradigms do not uniquely correspond to such broad, and even hard-to-define, cultural labels. For example, it is possible to interpret Keynes as either a modernist or a postmodernist (see, for example, Dow 2002: 124; Dow 2001:73)<sup>1</sup>; the same applies to general equilibrium theory. However, in my view these labels help clarify which interpretation of theories are bound to prevail in different times as well as define their limitations.

When seen in this light, Keynes appears inadequate to contemporary eyes for a number of reasons. To label him as modernist means, for example, that he is committed to

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<sup>1</sup> For an interpretation of Keynes as a postmodernist, see, for example, Cullemborg, Amariglio and Ruccio 2001, Ruccio and Amariglio 2006 and Klammer 1995

a static, economicist approach placing the emphasis on the 'intrinsic' anatomic features of capitalism rather than 'interactionist' dynamic properties: that is, features which are not 'spontaneous' but result from the evolving interaction between institutions and agents' behaviour. These properties reflect postmodern trends are at least partly captured by anti-Keynesian post-war developments in macroeconomics, such as the famous Lucas critique, which stresses an interaction between policymakers and agents, calling into question the simplicity or linearity of modernist policy recipes.

On the basis of all this, what I ultimately hold in this paper is that a restatement of the Keynesian stance can only succeed if it is able to absorb the lessons taught by these more recent developments. This means that we have to follow something like a 'neomodern' perspective, seeking to combine both modernist and postmodern features<sup>2</sup> and suggesting a new simile to describe the economists' task: they should be more like neurologists, rather than dentists, as Keynes suggested: that is, more concerned with dynamic connections than with simple anatomic considerations.

The aim of this paper is not to provide a full-blown account of this alternative paradigm but simply to indicate its basic ideas, such as the need to pursue a more explicit 'dynamic' perspective, considering the Keynesian propensities to consume, invest and hold money as malleable, conventional and historically-contingent variables rather than mere psychological data. In this way it is possible to account for changes in aggregate demand due to factors such as *endogenous changes* in collective confidence and income and wealth distribution.

To deal with these issues, this paper is organized as follows. Section 1 presents an overview of Keynes's modernist claims. Section 2 discusses the links between standard macro and postmodernist views. Section 3 focuses instead on the neomodern perspective.

## **1- Keynes's 'high' modernist approach**

As noted by Phelps (1990), Keynes can be regarded as belonging to the stage of 'high' modernism in the early 20th century. Modernism refers to a vast cultural movement that flourished between the end of the 19<sup>th</sup> and the early decades of the 20<sup>th</sup> centuries and that criticized the trend towards modernisation. Strictly speaking, it is also a heterogeneous movement. On the one hand, as noted by McCloskey (1986), it is related to the Age of

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<sup>2</sup> This perspective is discussed at greater length in Togati 2006.

Enlightenment and its positivistic methodology (inspired by philosophers such as Descartes, Hume and Comte) and was concerned with establishing the foundations of knowledge and certainty (we can label this as 'official' modernism). Among its leaders, McCloskey lists Russell and Hempel. On the other hand, modernism also includes quite different (i.e., non-positivist) landmarks, such as the critique of old rationalism, positivism and utilitarianism carried out by Nietzsche, Freud, Weber in philosophy, psychology and sociology, the musical innovations produced by Schoenberg, the Cubist revolution in painting and sculpture, the international style in architecture and the subjectivist turn in literature where writers such as Strindberg, Ibsen, Pirandello and Brecht, for example, emphasise that individuals do not possess a unifying character but exhibit a multiplicity and contradictory nature of levels of consciousness (see, e.g., Kumar 1995: ch. 4). In regard to these contributions, we can speak of 'high' modernism.<sup>3</sup>

In the light of these remarks, it seems that Phelps is right to regard Keynes's emphasis on the sharp rejection of Classical doctrines, the irreducible multiplicity of perspectives, the end of 'objective truth' and the system's disequilibrium as being in line with these revolutionary, 'high modernist' thinkers (1990: ch. 1). This view has also been recently confirmed by Klaes (2006), who stresses that Keynes was at the core of the most prominent British modernist movement of the time—i.e. the Bloomsbury group—and 'his work displays the central hallmarks of literary and artistic modernism' (*ibid.*: 258). Among the features of the movement mentioned by Klaes, the following are especially relevant to Keynes: (a) emphasis on avant-garde, revolutionary views; b) linguistic innovations and stylistic changes; c) an attempt to break with history; d) rejection of realist models of representation; e) preoccupation with form and technique; f) striving towards uncovering invariant structures of reality; g) belief in progress.<sup>4</sup>

#### *a) Avant-garde, revolutionary views*

In the *General Theory*, Keynes attempts a bold generalization in various respects. Like

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<sup>3</sup> 'Official' modernism has prevailed in the literature; i.e., the label has been associated mainly with positivist views justifying the emphasis on linearity, stability and steady progress. For example, McCloskey (1986) suggests that modernism is anti-historical in its preoccupation with foundations or certainty, endorsing scientism in holding that the boundaries of genuine knowledge coincide with those of science, relying on old-fashioned paradigms of physics and the understanding of science in axiomatic terms, with a primary focus on prediction, control, observation, experimentation and measurement. Among the commandments of modernist methodology, McCloskey also includes explanation in terms of covering laws and a clear distinction between ends and means (see also Boylan and O'Gorman 1995: 39).

<sup>4</sup> These features also have a counterpart in contemporary scientific breakthroughs, such as relativity theory. Significant analogies can be found for example between Keynes and Einstein (see in particular, Galbraith 1996, Togati 1998, 2001).

Picasso with his cubist painting, for example, Keynes considers 'all sides at once' in his analysis of stability (e.g. regular business cycles, states of depression and long-run growth concerns). Moreover, he overcomes the dichotomy between the monetary and the real sector of the economy in order to account for its internal instability.

*b) Linguistic innovations/stylistic changes*

In line with several strands of modernism that sought to proceed to autonomous analysis of subsets of social or natural science based on different principles, Keynes fights to establish the peculiarity of his macro approach, dealing with the economy as a whole, in contrast with Marshallian microeconomics, based on the partial equilibrium approach. This struggle is clearly reflected in the linguistic innovations he adopted, such as his anti-reductionist metaphors or the view that the economist should be like a dentist, which well reflects his systemic approach as well as its scientific and therapeutic nature.

*c) Attempt to break with history*

Keynes's attempt to emancipate himself from the Marshallian orthodoxy leads him to break with history, in the hope of achieving a high degree of applicability to most contexts. He provides an essentially abstract or '*a priori*' account of the working of the economy. In his analysis of the role of money and banks he admits, for example, that institutional details fall into the background. Moreover, he focuses on actual observation of markets and business psychology only when discussing notions such as expectations and the state of confidence in chapter 12 of his book (see e.g. Keynes 1936: 149).

*d) Rejection of realist models of representation*

When compared to the institutionalist and historical school, the *General Theory* shows a more reflexive and inward-looking concern with representation. In line with Woolf's rejection of the realistic novel and the refusal of naturalistic data in modernist painting, Keynes rejects one kind of realism, namely descriptive realism, to embrace a psychological perspective. In contrast with the 'rational economic man' of standard theory, Keynes emphasizes the fragmented nature of individual identity and experience in an uncertain context: he stresses both the key role played by irrational moves in agents' decisions and the stabilizing role of conventions (Klaes 2006: 262).

*e) Preoccupation with form and technique*

There is no doubting that the *General Theory* greatly contributes to the development of



macro and national accounting as technical disciplines. This is so because it provides a model; i.e. a coherent framework, including precise definitions of the core concepts. As he makes clear in chapter 18 of his book, Keynes—not unlike contemporary revolutionary theorists in other fields, such as Einstein, who stressed the non-homogeneity of time—develops a seemingly ‘static’ approach. He focuses mainly on how the key causal factors involved by the principle of effective demand give rise to momentary positions of rest in the system. While always applying in the determination of income at any given moment, this principle cannot be regarded as generating natural laws concerning the evolution of income through time.

*f) Striving towards uncovering the invariant structures of reality*

In line with contemporary modernist movements, Keynes too fails to pursue formalism and abstraction as ends in themselves; they are needed not to depart from reality *tout court* but to capture its essential part beyond contingent or transient elements. Indeed Keynes can be regarded as adhering to the canons of modernist avant-garde painters, according to whom reality has an objective existence and unifying forces await discovery so that the basic aim of abstraction is to isolate the fundamental invariant or deep structures that underlie appearances:

Representation of the invariant structure required, it was believed, the development of abstract and formal methods. If the abstract, geometric paintings of Piet Mondrian and Malevitch seem removed from reality, they actually are intended to be realistic in the sense that they probe and represent ‘deep’ reality.

(Klamer 1995: 321)

In particular, not unlike Kandinsky's 1911 manifesto stressing that the move towards abstraction 'liberated the artist from the constraints of figurative representation, towards an exploration of the symbolic primitives of the visual field...' (quoted by Klaes 2006: 266), the *General Theory* seeks to isolate the primitives of the macroeconomic field. According to Keynes, these consist of the intrinsic properties of a monetary economy, in which money and expectations play an essential role and make sense of the principle of effective demand. It can be argued that his fundamental contribution is to provide the anatomy of modern capitalism, an analysis of its basic elements at a given moment in time. From this standpoint, his work parallels the achievements of Einstein's relativity

theory, which introduces time as an essential dimension of the analysis (see Togati 1998: 45-61).

### *g) Belief in progress*

Keynes certainly shares another basic ideal of the modernist movements, which is aptly described by Klammer as follows: 'Far from retreating into an abstract world removed from the real one, these early modernists were utopian ... [They] strove for ideals of emancipation and liberation and worked for a better world' (Klammer 1995: 321). In line with the dentist metaphor, Keynes quite optimistically regarded his theory as being the right tool in the hands of policymakers to cure the 'tooth-aches' of the economy most effectively. This sort of belief has often been translated by both academics and journalists in simplified policy formulas, such as the possibility to jump-start the economy or the 'pump-priming' concept.

## **2- The New Neoclassical Synthesis and postmodernism: some plausible links**

Postmodernism can be seen as the cultural correlate of a post-industrial society, in which knowledge has become the principal force of production (see Lyotard 1984: 5; also Preston 2001: 82). Many authors suggest that postmodernism has not much affected economics (see e.g. Dow 2001, 2002, Jackson 2009) and certainly neoclassical theory may appear very far from its influence. The general equilibrium approach is widely regarded as an application of modernist principles in economics. As clearly stated in Samuelson's 1947 contribution, for example, this approach aims to build a universal model around the unifying principle of maximization under constraint (see, e.g., Dow 2001: 67). However, general equilibrium can also be given a postmodern interpretation. As Phelps suggests, for example, the Real Business Cycle model—which lies at the heart of today's dominant macro paradigm, i.e. the New Neoclassical Synthesis (NNS)—can actually be seen in this light. In this section, I will justify this view by singling out some of the most plausible links between the NNS and postmodernism.

### *a) Eclecticism*

Following its refusal of grand meta-narratives, such as Marxian theory, postmodernism

favours eclectic tendencies that attempt to combine old and past features. The NNS appears to be in line with this move as it combines new formal tools with past theoretical beliefs and methods. It reverses Keynes's 'all-sides-at-once' approach to pursue segmentation of the whole macro discipline, not just between business cycle and long-run growth theory, but also within an increasing number of uncoordinated, partially autonomous subfields, such as labour, money and finance. More generally, it can be argued that much of mainstream economics is characterised by a certain amount of fragmentation; macroeconomists apply the standard assumption of rationality in piecemeal fashion in a variety of contexts, quite outside any unifying logic of a Walrasian kind. This is especially evident in the literature on the search for the microfoundations of macro. This has led many to emphasize a variety of partial equilibrium stories based on a plethora of special assumptions that defy generalization (see, e.g., Blanchard and Fisher 1989: 27-8; Caballero 2010).

#### *b) Linguistic innovations*

One of the key aspects of postmodernism is its calling into question the autonomy of various subsets of social science and the lines of demarcation between various realms of society or between nature and society or culture.<sup>5</sup> This accounts for key tendencies in postmodern culture, such as reductionism and the increasing role of advertising. In line with this stance, the various strands of neoclassical macro theory and the NNS have now dropped Keynes's systemic thinking and persistently advocated the search for the microfoundations of macro as the basic criterion for producing acceptable economic science, not unlike advertising campaigns stressing, for example, the virtues of a particular electronic device to enhance the quality of life. Indeed, it can be argued that the marketing strategist, rather than the dentist, has become the relevant metaphor for the economist. The aim is not so much to solve or cure specific problems, for it is difficult to know whether a specific remedy works or not (deregulation may fail because it is not implemented properly etc.). Rather, the aim is to discover the right rhetorical arguments to 'impose' the model upon the economy in a soft way through a fundamental 'interaction' between theorists and agents; that is, by shaping their expectations by reassuring or convincing them that the standard model is the only 'true' model of the economy, the only acceptable grammar or correct framework for thinking as economists and deriving plausible normative conclusions.

**c) *Attempt to account for history***

Another feature of postmodernism which is somehow captured by the NNS is its concern for the historical dimension. While still committed to abstract axiomatic theory and even claiming to search for natural laws governing market economies—in particular by deducing business cycle theory (not just long-run or growth theory) from the correct neoclassical postulates—standard macro theorists have ceased, for example, to regard the economy as a kind of self-contained machine, separated from the institutional set-up. The market system can only work if there are adequate institutional premises, such as law enforcement and property rights, or institutional anchors, such as a certain academic set-up capable of popularising or imposing the 'true model' of the economy to coordinate agents' expectations, as implied by the rational expectations hypothesis. Institutional differences between countries may account for their divergent economic performances.

**d) *Appreciation of descriptive realism***

In line with postmodernism's appreciation of elements that comprise pure surface (i.e., the view that 'surface is everything'), standard macro theorists often subscribe to a form of descriptive realism. While relying on patently and descriptively false abstractions or assumptions and even defending them as virtuous in line with Friedman's 'as if' stance, Lucas, for example, argues that the task of his model is to mimic actual co-movements; i.e. those invariable regularities or stable patterns among data series. Another 'descriptive' feature that modern macro has in common with the original general equilibrium theory of the 19th century is its focus on 'observable' elements, such as individual agents, as the key ontological feature of the economy.

**e) *Technique/form as 'ends in themselves'***

In line with the 'linguistic turn' emphasized by postmodern thought and the so-called 'rhetorical' approach to understanding economics developed by McCloskey (1986), the NNS—in comparison with modernist authors—certainly does not drop formal models, but it changes their interpretation. While sticking to the same Walrasian paradigm as the older generation of neoclassical theorists, it tends to consider its general equilibrium models as narrative elements, as 'tales' rather than 'true' representations of the economy as Walras himself or Samuelson would (see e.g. the latter's emphasis on the realism of assumptions). In other words, it is possible to see NNS models as reflecting a 'linguistic' or technical turn, according to which what matters is not the 'true' representation, but simple internal

consistency or the technical ability to construct tales. It should be clear that a degree of indeterminacy inevitably follows from this perspective. On what grounds should we prefer one model to the other? Simple reference to basic postulates is not the decisive criterion. The point is that analytical results are obtained mainly due to the use of technical assumptions that are not uniquely related to such postulates. For example, like Real Business Cycle theory, the NNS places the emphasis on real shocks. But in the recent past, similar representative-agent based models emphasizing monetary shocks instead (e.g. Lucas's models) were also popular. It is difficult to say that the former is 'better' than the latter in some objective sense, apart from conformity to conventional criteria such as rigour, simplicity, parsimony etc.

*f) Are there any invariant structures?*

As already noted, according to popular accounts, postmodernism puts forward the view that 'surface is everything'. Moreover, it also contrasts the use of discourse analysis as a search for 'meaning' (inevitably context-dependent) with the modernist programme of searching for 'truth'. In our view, however, these claims should not be taken at face value, especially when dealing with the influence of broad postmodern culture upon scientific subjects, such as economics. The obvious fact that NNS authors continue to use modernist concepts, such as the 'deep' parameters or 'truth', does not mean *per se* that they are immune from postmodernism; in my view, the latter does influence the interpretation of such concepts.

First, while the NNS approach does not rule out the emphasis on 'deep' parameters, in line with the modernists' search for the unchanging primitives of the economic field, on close scrutiny, however, it does call into question their invariant nature. One can note, for example, that in standard macro approaches, institutions influence individual behaviour at least in the long run (growth theory) (see e.g. Rodrik 2003: 1). Moreover, the rational expectations hypothesis introduces some dynamic, interactionist elements in standard models, such as the fact that people react to policy. Now, according to this hypothesis, it is because agents' preferences remain stable in the face of policy changes that one can rely on standard models to predict agents' reactions to such changes. However, there is also a further dynamic element to consider: namely, that the scenario just described is true only if all agents know the standard model. But if this model is to be applicable to the real world populated by heterogeneous agents, one imperative question naturally arises: how do they manage to learn this model? To address this issue implies recognizing the full potential of the interactionist perspective as 'deconstruction', to use a postmodern term, of the notion

of the 'rational economic man' as an autonomous or context-independent entity underlying the modernist versions of neoclassical theory .

Second, while the NNS approach, like the modernist one, does not drop the term 'truth' (and reference to external reality) altogether from its language kit, it does use it in a quite different sense. The linguistic turn for the NNS does not literally mean what postmodernist authors such as Roland Barthes have in mind; namely, that no fundamental reality exists outside language and discourse; i.e., the view according to which 'everything which we encounter or experience as 'reality' is only (or primarily) a matter of language or text or discourse—that is essentially forms of information—rather than external things (there is no "out there", as it were)' (Preston 2001: 87). It does mean, however, that the relationship with external reality is much more tenuous and is mediated by technical language in an essential way.

On the one hand, provided they can be interpreted as essential structures underlying reality, deep parameters must carry the weight of an enormous analytical superstructure built upon them. Indeed, it is true that in the process of deriving analytical conclusions, all the work is done by technical assumptions which introduce wide margins of manipulation in modelling procedures (see e.g. Lawson 1997). On the other, the 'empirical evidence' for such theorists is not synonymous with 'brute facts': it is only what econometric techniques identify as such (e.g. statistical correlations or regularities behind the chaotic surface; i.e., the mass of actual data). The combination and overlap of theory and econometric techniques along these manipulative, technical lines lead Lucas, for example, to regard the so-called co-movements as the only characteristics of the business cycle worth considering in the analysis. Moreover, they justify reliance on calibration approaches, according to which evidence can be chosen to satisfy the theoretical value of parameters,<sup>6</sup> an approach which makes theories almost unfalsifiable, despite the formal appeal to empirical testing as the ultimate judge, and attaches a strong conventionalist connotation to the notion of 'true model' of the economy.

### *g) Weakening of the concept of progress*

Another feature of postmodernism is the emphasis on the 'negative' aspects of phenomena from the start, asserting that they do not possess linear outlines in our society, and that simple accounts for them may not hold (see e.g. Culleberg, Amariglio and Ruccio 2001:

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<sup>6</sup> As rightly noted by Jespersen, 'the deep parameters ... were calibrated, that is, given empirically plausible values, without necessarily being anchored by formal statistical tests. It is considered more important that parameter values respect the theoretical requirements of a well-behaved general equilibrium model' (Jespersen 2009: 28).

9). This clearly undermines the modernists' optimistic belief in the possibility of achieving progress through intervention. Following this stance, the NNS raises serious doubts about Keynes's optimistic belief that governments are able to steer the economy.<sup>7</sup> By assuming that agents think in terms of the standard model, it stresses that agents react to the implementation of Keynesian demand policies, thus undermining their effect at the aggregate level (for example, if more debt-financed public expenditure occurs, rational consumers may discount future taxes to cover it by reducing current consumption). In this way, a fundamental interaction between agents and policymakers is recognized, in line with the view that the market economy is not a self-contained mechanism. It follows from here that, in order to grant macro stability, policymakers need to commit themselves to clear policy rules, such as balanced budget or inflation targeting, that minimize the risk of agents' adverse reactions.

### **3. The limitations of Keynes in the light of the neomodern approach**

The key suggestion of my paper is that to deal with current macroeconomic problems simple reference to Keynes is insufficient; there are significant limitations to his approach. This is clearly not a new claim *per se*. Critiques have been raised on his *General Theory* ever since it was published. by friends and foes alike.<sup>8</sup> Below, I do not discuss such critiques; I only suggest that they are often partial or limited to particular aspects. My basic concern here is to indicate a novel perspective from which Keynes's limitations can be more easily understood in a *comprehensive* way. I label this perspective as 'neomodern'. since it combines both modernist and postmodern features. In a nutshell, what I hold is that while Keynes's approach is a milestone of macro, its key achievement is to uncover the anatomy of capitalism. It fails to provide instead a sufficient account of its dynamic properties, such as the 'internal relation' between policymakers and agents (for example, the fact that the latter react to policy moves), partly emphasized by postmodern macroeconomics. In this section, I provide only a brief sketch rather than a complete account of this perspective; my aim is to show that it is potentially fruitful and

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<sup>7</sup> As Dow points out (2002: 123-5), postmodernism thus justifies the new wave of liberalism and this results in a shift from demand management towards the privatisation of public sector activity. It also validates the challenge made by the rational expectations theory whereby the idea that government has superior access to knowledge that would warrant government activism.

<sup>8</sup> For example, Jespersen (2009: 37-50) mentions a long list of weaknesses of Keynes. This book provides a very useful background analysis for this section.

constructive: namely, that it can help to pursue 'macroeconomics in the spirit of Keynes'.

*a) What general theory?*

First of all, the neomodern perspective involves a critique of Keynes's generalization effort. His 'all-sides-at-once' approach is certainly more useful than the neoclassical eclectic approach based on segmentation and partial equilibrium stories. However, it would work better if its limits were clearly specified. Keynes, for example, apparently attaches the same weight to the general principle of effective demand or the multiplier, which are part of his 'static' model, and command a wide consensus among economists and to 'dynamic' claims, such as those concerning prices and costs changes, which reflect particular assumptions (e.g. decreasing returns) that appear more questionable. In other words, I feel that we must somehow take into account the postmodern critique, that some degree of segmentation in Keynes's original theory is needed, though of a different kind from the one usually suggested in the literature. In particular, I hold that we should make a hierarchical distinction between the two above sets of propositions. Although I cannot fully justify my labels here, I would simply regard the static core of the *General Theory* as Keynes's 'True Model' and the other part as his 'Hypothetical Model'.

*b) Linguistic innovations/stylistic changes*

To describe how the neomodern perspective differs from Keynes's, it is useful to adopt a new metaphor for describing the economist's task. While sticking to the basic medical metaphor, I hold that economists should regard themselves as neurologists rather than dentists. In their view, the brain appears more complex than other organs. It has not just an objective, out-there, existence, like a tooth: it is not, for example, just an aggregate of cells (as one could expect by looking at it at a given instant of time); it is also about dynamic connections, which are partly constructed through the interaction with the external environment in 'real' time. Such connections cannot be derived from the knowledge of static properties alone and are not the spontaneous result of evolution; that is, they could not exist without human intervention or cultural influence. In other words, the brain appears to be the part of the body for which 'self-contained' anatomic analysis is most insufficient; indeed, it is not easy to tell the boundary between biological 'spontaneous' evolution and external or cultural influences. Neurology therefore appears as the realm of autonomy of the dynamic connections from simple anatomic structure, partly due to cultural influences or 'learning'. While this introduces a degree of indeterminacy in



science (the brain is mostly unknown, like economic growth), it does not amount to 'anything goes' (we have at least a sufficient static knowledge of the brain).

*c) History and theory as compatible bedfellows*

A further feature of the *General Theory* that the neomodern perspective invites us to call into question is its relatively abstract or a-historical approach. The novelty of this perspective, however, is the belief that accounting for the proper role of history and institutions as advocated by postmodern developments does not necessarily involve the rejection of Keynes's generality claim. On the contrary, it is the ability to 'generalize' the NNS interactionist insights that opens the way to a successful restatement of that claim.

To make this point clear, let us first note that the key limitation of Keynes is that he subscribes to a 'self-contained' or economicist stance. While allowing for the internal instability of the economy, he fails to consider the 'internal relation' between policymakers and agents or what happens when the factors which he takes as given in his static model are allowed to change. As for the first point, it can be argued that what Keynes fails to notice is that, under the fiat money regime, institutional premises or anchors need be established because agents may lack a sufficient amount of confidence in the working of the economy and the basis of their decisions. In particular, while stressing the fragility of the conventional background, Keynes does not provide a dynamic account of 'confidence' and the institutional response which occurs when it breaks down.

This is the key step that neomodernists should take to restate Keynes's original generality claim. For this purpose, it is vital to single out the relevant anchors granting stability in real world economies. Indeed, ever since the Great Depression these have increasingly been 'tamed' by intervention in the shape of internal anchors, which have become endogenous, built into the system. While Keynes was thinking mainly in terms of quite reversible discretionary demand policy moves, many systemic stabilizers have become structural, almost a 'natural' or uncontroversial part of the institutional landscape. I refer to 'official' mechanisms, such as given money wages, the pledge of central banks to defend the value of money, key features of the welfare system, such as unemployment benefits or public health services, deposit insurance etc.—which have accounted for the structural rise of public expenditure over GDP in all advanced countries ever since the 1930s—as well as to some more subtle or tacit mechanisms through which institutions shape aggregate behaviour. We can think, for example, of 'popular' models or theories that are 'institutional' in the sense that they are strongly supported by academia and influence policymakers to the point that they provide almost common-sense accounts or policy

solutions. There is no doubting that people's unconditional belief in most sophisticated models claiming to provide a scientific analysis of risk is one of the key factors that led to the recent expansion of financial markets and the subsequent crisis.

On these grounds, our generality claim can now be made clear. When seen through neomodern lenses, Keynesian theory is more general than its neoclassical counterpart because it advocates a broader range of institutional anchors or stabilizers. Standard theory actually implies that the economy is internally stable and that 'right' institutional set-ups and policy regimes as well as the standard model itself are sufficient to support agents' confidence. Based on Keynes's view that the economy is not internally stable, the neomodern stance underlines instead that there is no guarantee that institutional anchors can actually succeed in this confidence-restoring task. Ever new forms of anchors need to be devised for this purpose.

#### *d) What kind of realism?*

Another feature of Keynes's approach that appears questionable in the light of the neomodern stance is that he formulated his principle of effective demand by appealing to explanatory factors, such as psychological and conventional terms, unsuitable to account for the evolution of the economy. The point is that they seem, to a large extent, descriptive terms which have no clear ontological status, as they fit neither a full-blown individualist ontology (Keynes's aggregates defy the canons of individual rationality), nor a full-blown aggregate ontology insofar as he makes reference to maximization and 'animal spirits' that are ultimately in tune with an individualist ontology and a narrow notion of structure.<sup>9</sup>

The neomodern stance advocates a way out of Keynes's ambiguity in the opposite direction to the microfoundations strategy: that is, it regards aggregates as distinct ontological entities relating to concepts, such as 'collective confidence', which acquire a special status and do not result from the aggregation of individual mental states. This is possible because while endorsing his view that conventions stabilize somehow animal spirits—a feature that accounts for his claim that the system is not violently unstable but only moderately so—I regard the relative stability of the conventional background itself, however, not as an intrinsic property of the system but as a result of the institutional anchors or what I label as the 'internal relation' between agents and policymakers.<sup>10</sup>

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<sup>9</sup> The debate which has occurred since the publication of Akerlof and Shiller's 2009 book on animal spirits cannot be addressed here. For interesting comments, see e.g. Dow and Dow (2011).

<sup>10</sup> This explains why the neomodern stance advocates a macrofoundations perspective: this amounts to stressing the existence of irreducible systemic or institutional determinants of individual behaviour, so that one cannot derive conclusions about macro stability from micro analysis alone.

Placing the emphasis on this relationship actually makes it possible to recast Keynesian theory in dynamic terms. Indeed, the key drivers of the theory; i.e. agents' propensities underlying aggregate demand now appear as malleable variables because the 'collective confidence' influencing them does not have a static nature, but must be continuously reproduced by appropriate institutional mechanisms. Once this step is taken, one can discuss the evolution of aggregate demand in terms of determinants of 'collective confidence', including objective factors, such as trends in globalisation, technological change and finance, that affect income and wealth distribution. This is possible because 'collective confidence' appears more as a structural rather than a simple psychological feature. For example, it is not just about waves of pessimism or optimism but about structural changes, such as people's tendency in the New Economy to use less paper money, which reduce their propensity to save or increase their propensity to go into debt as a consequence of financial innovations.

*e) What role for formal models and story telling?*

The neomodern perspective also involves a critique of Keynes's literary form of exposition. This is not effective mainly because Keynes fails to specify the boundaries between his 'True Model' and the 'Hypothetical Model', a feature which undermines his dynamic analysis; he gives the impression, for example, that this could consist of a priori claims, such as the tendencies of the propensity to consume or the marginal efficiency of capital to fall. To remedy this flaw, neomoderns advocate a two-step approach. The first step is to provide a formal representation of his True Model (for example, in terms of a fixed price IS-LM model)<sup>11</sup> in order to isolate the primitives of macro and thus the role of aggregate demand at a given point in time. The second step, in line with Keynes's non-homogeneity view, together with our emphasis about the 'internal relation', is to recognize that dynamic analysis does not lend itself to formal treatment and thus regard Hypothetical Models in general as a form of story-telling, concerning how the 'primitives' singled out in the True Model are influenced by the combination of trends mentioned above.

*f) Deep but changing structures*

The neomodern stance subscribes to Keynes's modernist project whereby we should single out deep structures, such as the primitives of effective demand. However, following postmodern views, it regards such deep structures as being changeable. In particular, while

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<sup>11</sup> I cannot justify this claim here. For a more detailed argument see Togati 2012.

Keynes affirms the possibility of a lack of effective demand as an anatomic feature of capitalism, the result of some 'generic' features of capitalism, such as money and uncertainty, in the neomodern perspective a lack of effective demand is not a static phenomenon which can be discussed simply in terms of underemployment equilibrium, but should be analyzed in dynamic terms. This means, for example, that it is important to understand its origins, how it results from changes in the primitives of effective demand brought about by some key trends or phenomena occurring in historical time (e.g., those features that characterize the New Economy, see Togati 2006). Moreover, a lack of effective demand also implies that a confidence crisis is under way which must be checked by appropriate institutional stabilizers and expectation-coordinating devices. This internal relation between agents and institutions thus implies that economic data are not 'objective' in the sense that they are not entirely spontaneous or 'natural' but incorporate a policy response.

For these reasons, dynamic analysis can only be about plausible 'stories' aimed at discussing broad qualitative features or tendencies of the economy rather than precise quantitative relations. The 'story' label suggests that there is a degree of creative selection or manipulation of evidence involved in this representation of reality, which is the postmodern heritage that survives in the neomodern stance. Such dynamic stories should be mainly concerned with one major point: namely, how to split up the overall aggregate evidence into more or less 'spontaneous' trends; i.e. tendencies of the economy irrespective of policy influence (this is needed to substantiate claims about endogenous instability) on the one hand, and counteracting policy moves on the other. In principle, many stories are possible and many different combinations of these trends can be produced (I provided an instance of such combinations in Togati 2006).

#### *g) A more roundabout approach to progress*

The last feature of Keynes's approach that the neomodern approach calls into question is his belief that 'progress' (in particular, the possibility to remedy the lack of effective demand and the existence of involuntary unemployment) is relatively easy to achieve. Using his dentist simile, it can be argued that in his view demand policy is not unlike a tooth which can be pulled out at a relatively minor cost (as compared to other types of surgical operations). According to the neomodern stance, instead, progress can still be achieved but in a more roundabout way.

This claim is justified by the fact that, following the neurologist metaphor, we seek to go beyond a simple anatomic account in order to understand better the actual evolution of

the economy. There is no doubting that the latter has undergone major changes ever since the 1930s. In particular, it has been increasingly ‘tamed’ by intervention in the shape of internal anchors, which have become endogenous, built into the system. Now the reason why this change makes the road to progress much more impervious is that it has been generally misinterpreted by academics and policymakers alike, generating a curious paradox. Instead of been regarded as an intellectual victory of the Keynesian paradigm, according to which stability is not intrinsic to the system but can only be achieved by intervention, the relative stability of post-war capitalism has been seen in opposite terms, that is, as a justification of the standard paradigm affirming the intrinsic stability of the economy in which problems are due to excessive state interventions. Indeed even the recent crisis—in which an unprecedented creation of liquidity and public deficits has so far avoided something like the Great Depression happening again—has now created the conditions for the intellectual resurgence of standard theory in the shape of orthodox policy recipes, such as the drastic welfare cuts advocated by US tea party movements or many European leaders and the punishment of profligate countries by financial markets.

In this context, sustainable progress can then only be achieved by adapting the Keynesian paradigm to these new conditions (in particular, making it able to capture the relevant interactionist properties) in such a way that it becomes easier for people to believe the stories it is able to tell.

## **Conclusion**

The basic conclusion of this paper is that to understand both the achievements and the limitations of the *General Theory* we need to rely on a new paradigm, such as the neomodern perspective proposed here, which invites us to combine the insights of previous modern and postmodern stages of macroeconomics in order to improve the analysis of global stability. This perspective, which leads us to adopt the neurologist as the relevant metaphor for economics, makes clear, for example, why Keynes’s work is a scientific landmark in the history of economics: it is an invaluable contribution to unveiling the anatomy of capitalism. However, it also helps us to understand his weaknesses in dynamic analysis. Just as the brain is not only about anatomy, so capitalism cannot be entirely understood in terms of a static model of instantaneous equilibrium such as that underlying the *General Theory*. In particular, we have noted that Keynes’s work fails to highlight the dynamic implications of the working of an economy based on fiat

money, which are relevant for assessing the stability of real world economies. For these purposes, it is necessary to take into account not just some spontaneous trends that can be inferred from anatomy as he did (such as the tendency of the propensity to consume or invest to fall), but also the systematic ‘internal relation’ between policymakers and agents, which undermines the possibility to talk about the dynamics of capitalism in an objectivist, abstract or high-brow theoretical way. In particular, to study this relation two steps need to be taken. The first is to consider collective confidence as an autonomous structural (rather than simply individual and psychological) feature which responds to changes in objective factors. It has been noted, for example, that financialisation (combined with other trends) has increased confidence in the stability of the financial system and has brought about structural changes in people's behaviour (as distinct from simple waves or optimism or pessimism), such as the tendency to use less paper money and reduce their propensity to save. The second is to single out the relevant endogenous anchors which have been granting stability in the real world economies ever since the Great Depression.

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