An impossible crash brought Keynes back to life

It seemed that the great economist was history - just like the Great Depression. But recent events have proved him right

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When Alistair Darling said that “much of what Keynes wrote still makes sense”, anyone under 40 might well have asked: “And who on earth is Keynes”?

When I first started writing about him in the early 1970s, John Maynard Keynes was a name to conjure with - not in the league of Led Zeppelin, to be sure, but certainly familiar to the mythical educated layman. Economic policy was “Keynesian” - that is, governments aimed to keep unemployment below the “magic” figure of one million, as they had for the previous 30 years, by expanding public spending or cutting taxes.

Then Keynesian policy suddenly became obsolete and the theory that backed it was consigned to history's dustbin. He might have been a great economist, right for his times - the Great Depression of the 1930s - but he had nothing to offer the modern world, and moreoever was responsible for the “stagflation” of the 1970s. In her assault on inflation, Margaret Thatcher put the Keynesian engines into reverse and created three million unemployed. Keynes seemed as dead as the dodo.

In fact, while dead to the public, Keynes lived a ghostly half-life in the corridors of the Bank of England and the Treasury. In setting interest rates, the Bank continued to pay attention to what was happening to output, the amount of economic activity, as well as inflation - although

the inflation rate was its only “target”. Gordon Brown's fiscal rules allowed for the influence of the “automatic stabilisers”: the movement of the budget into deficit or surplus as the economy slowed or speeded up.

But basically the authorities relied on “managing expectations”, by the gentlest adjustments to interest rates, to keep us in perpetual non-inflationary boom; we lived in a world from which inflations and depressions had been banished, and for which Keynes was no longer needed.

For ten years the new formula worked. We were blessed with what Mervyn King, the Governor of the Bank of England, called a “nice” environment - a combination of strong growth in the US and Far East and the downward pressure on prices of a competitive globalising economy. More fundamentally, Keynesian economics was rejected by most of the economic profession as having caused inflation in the 1970s.

The main prescription of the “new” classical economics was to minimise the role of government and let markets do their job. It rested on an assumption that if economic agents are rational - the key assumption on which the claim of economics to be a science is based - the market system accurately prices all trades at each moment in time. If this is so, boom-bust cycles must be caused by outside “shocks” - wars, revolutions, above all political interference with the delicate adjustment mechanisms of the “invisible hand” of the market.

But this view has been blown sky- high by the present crisis. For this crisis was generated by the market system itself, not some outside

"shock"; moreover, within a system that had been extensively deregulated in line with mainstream teaching. The automatically self-correcting market system to which the economics profession has mostly paid homage has been shown to be violently unstable. And this is exactly how Keynes expected it to behave.

What was left out of the mainstream economics of his day, and its "post-Keynes" successor, was the acknowledgement of radical uncertainty. "The outstanding fact," he wrote in his magnum opus, The General Theory of Employment, Interest and Money (1936) "is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made". We disguise this uncertainty by resorting to a variety of "pretty, polite techniques", of which economics is one, "which try to deal with the present by abstracting from the fact that we know very little about the future".

But any view of the future based on "so flimsy a foundation" is liable to alternating waves of irrational exuberance and blind panic. When panic sets in there is a flight into cash. But while this may be rational for the individual, it is disastrous for the economy. If everyone wants cash, no one will lend. As Keynes tellingly reminded us "there is no such thing as liquidity... for the community as a whole". And that means that there may be no automatic barrier to the slide into depression, unless a government intervenes to offset extreme reluctance to lend by huge injections of cash into the economy.

This is exactly what world governments have been doing, in defiance of the contemporary theory that tells them that the huge mispricing of debt which provoked the present meltdown is impossible.

What the Chancellor rightly pointed out is that the rescue of the banking system may not be enough to avert a deep recession, and a fiscal stimulus may be needed. The International Monetary Fund is predicting that output will fall short of trend by 1.05 per cent of GDP this year, rising to 3.16 per cent next year. With unchanged policy, the result may well be three million unemployed by the end of next year. Yes, the economy will ultimately correct itself without government stimulants. But it may take a long time, with huge damage while the required "corrections" are taking place. This is the case for a Keynesian rescue operation.

Beyond the ambulance work, there is the question of working out a policy framework, domestic and international, that will at least minimise the danger of these self-destructive market-generated storms arising in future. Politics, of course, will compel all kinds of new regulations, good and bad, to rein in the wild excesses of recent times.

But politics is blind: the politicians are like passengers on the Titanic rushing to the lifeboats. But unless their policies are backed by a more adequate theory of economic behaviour than is currently available they will not survive when times return to "normal". Keynes tried to supply that theory. He may not have clinched his case, but even his arch- critic Milton Friedman conceded that it was "the right kind of theory" for his times. Because the possibility of collapse is always present, Keynesian theory remains a better guide to policy than one that assumes that markets are inherently stable.

Keynes understood that it is ultimately theory that determines policy, and that one cannot for a long time justify policies that run counter to accepted theory. He also said: “In the long run we are all dead.” That is one observation which happily does not apply to him. Over to you, Darling.

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