

Teaching Keynes in the 21st Century

David Colander

A lot of discussion lately has been about how to present Keynesian economics in the principles course. Some new principles textbook authors treat Keynesian economics as an historical artifact, no longer relevant to current economic events.¹ Others, such as McConnell and Brue (1999), continue to make Keynesian economics the core of students' understanding of macro. I am firmly on the side of saving Keynesian economics, or at least something similar to what we now call Keynesian economics. I explain in this article what I mean by that, but first, I present the arguments that have been put forward for dumping Keynesian economics. Four reasons have been generally suggested.

REASONS FOR DROPPING KEYNESIAN ECONOMICS

1. As a guide to policy, the Keynesian model is wrong; it teaches students that deficits expand the economy and surpluses contract the economy. In the 1990s, however, deficits have been contracting, and the economy has been booming. Thus, we should abandon the Keynesian model and replace it with a presentation of the long-run relationship between deficits, interest rates, and growth. We should teach that deficits have little effect, or contract the economy, emphasizing the Ricardo equivalence theorem.²

2. Empirically, multiplier effects are not very large, and the consumption function is nowhere near as stable as it once seemed to be. Hence, as a basis for policy, the Keynesian multiplier model is almost unusable. Indeed, Robert Barro (1996) goes so far as to argue that the World War II deficit spending is not even an example of the multiplier working—even though unemployment was reduced from 14 percent to under 2 percent during that time. Barro argues that the economy did not expand much more than the increase in government spending, so therefore, no multiplier effect existed even then. And by induction, if not then, when?

3. The economy gravitates to a long-run natural-rate equilibrium on its own. It is not unstable as suggested by the Keynesian model. Thus, we should teach a model based on a concept of the natural rate of unemployment and its corresponding potential income toward which the economy always gravitates.³

4. The economy does not have cycles any more; hence cycles and stabilization policy are obsolete. Thus, the Keynesian model, which highlights cyclical fluctuations, is also obsolete and should be replaced with a model of long-run

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equilibrium growth. On the intermediate macro course level, that model is the Solow growth model; on the principles course level, it is a general discussion of steady-state growth with essentially no formal model.⁴

WHAT KEYNESIAN ECONOMICS SHOULD BE SAVED?

Although I argue that Keynesian economics should be saved, I want to make it clear that I do not want to save everything that has been swept under the Keynesian mantle. I am quite willing to jettison much of what has gone under the name Keynesianism. I am even willing to admit that a key reason for the decline of Keynesian economics has been the ambiguity about what is meant by Keynesian economics and that much of this ambiguity is traceable to inconsistencies in Keynes's writing. There have been numerous interpretations of Keynes, all supported by references to the literature. The debates resulting from these various interpretations have consumed a large portion of many brilliant researchers' time. I avoid those debates completely. Quite honestly, I do not care what Keynes said when; I do not care whether what I call Keynesianism is what Keynes really meant, and I do not think students care either. I am not even sure that Keynes really knew what he meant.

Nevertheless, there was clearly something there in Keynes's writings and in what goes under the name Keynesianism in the principles textbooks, that I believe is worth preserving and teaching to students. What is that something? To me, it is a vision of macroeconomics that differs from what has become known as the classical vision. Specifically, *it is a vision that does not assume that the market economy—left to its own devices—will necessarily gravitate toward a preferable equilibrium.* That is, it is the acceptance of the proposition that the economy is complex and that, theoretically, markets may not always lead to the optimal aggregate results. A person who accepts my interpretation of Keynesianism accepts that the market can, at times, gravitate toward an undesirable equilibrium for a period of time long enough to warrant the consideration of government action to modify that equilibrium.

Although I was never taught so in my principles course, a subset of classical economists fully accepted this vision, at least as being a possibility. It was only later, after I became interested in the development of ideas and read the classics in this light, that I learned that there was much more to classical economics than I had been taught. What I was taught was that classical economics was wrong and that Keynesian economics was the truth. What I was taught was a model that demonstrated that the aggregate economy was unstable—that is, if it deviated from its potential income, there was no natural tendency for it to return to that equilibrium. The macroeconomy needed direct government intervention to stabilize it. Keynesian economics was presented as a scientific truth to be contrasted with the classical incorrect way of looking at the world. That brand of mechanical Keynesianism ended long ago, and I am pleased that it did.

Recently, however, it seems that the pendulum has swung too far the other way. Now it is the subset of the classical vision that sees the unimpeded market as the solution to all our problems that is being taught as the scientific truth; it is

Keynesian economics that is being relegated to the dustbin of history. This tendency of macroeconomics textbook authors to swing from one extreme to another underlies the joke about the student who comes to visit the professor he had 25 years ago. Looking at the exam the professor is about to give the former student remarks that it is precisely the same exam that he was given 25 years ago. The professor responds that that is true; in economics, the questions always remain the same; it is the answers that change.

I am arguing for teaching macroeconomics without the pendulum—teaching that there is a tendency for the market to work fine on its own and for private institutions to adjust to the problems that develop. We also need to teach that, at times, the macro economy can experience serious coordination problems that may require government action.⁵ We need to teach both what is currently seen as the classical model, and simultaneously to teach the Keynesian model with the multiplier analysis that shows how reverberations from an initial shock can lead the economy to an undesirable position. Economic theory does not tell us what model is appropriate to what time period. That is a matter of judgment, and in that judgment reasonable economists may differ.

I believe that the large majority of economists would find this middle ground acceptable. But it is hard to stay on this middle ground. One of the reasons for this is that the two alternative views have not been allowed to coexist on the level of high theory. The debate about which of the two views is correct has filled hundreds of thousands of pages of journal articles, 99.9 percent of which are irrelevant to principles students. Specifically, at the principles level, all the debates about what might happen if there were instantaneous price-level flexibility, all the esoteric debates about wealth effects, and all the debates about whether Keynesianism was a theoretical or a practical revolution are beside the point.

Again, Keynes is partially to blame for this state of affairs. To distinguish his view from the classical economists' view, which also allowed that less than instantaneous wage and price adjustment could cause coordination problems, Keynes made his case assuming a perfectly competitive goods market. His policy arguments would have followed just as well if he had simply stated that institutionally wages and prices do not adjust instantaneously, and that these institutions require a price level that does not fluctuate "too much." If one assumes that some degree of wage and price level stability is required by the institutional core of a monetary economy, then that debate about what would happen if there were perfect price level flexibility becomes irrelevant.

In my view, all principles students need to know is that there is such a debate and that economics theory does not lead to a definitive conclusion about whether the economy gravitates toward a unique equilibrium within a politically acceptable period of time. To convey this to students, the principles textbook authors need only point out that, in the real world, wages and prices tend to adjust less than instantaneously and, in such a world, repercussions of effects of one market can influence other markets and lead the economy to undesirable outcomes.

This is not a highly controversial position. Monetarists would agree with it; and many of Keynes's classical contemporaries—the economists of the 1920s and 1930s—would also agree with it. In fact, about the only people who will dis-

agree with it are a few purely theoretical new classical and real business cycle economists. Consider the following quotation:

In the first place my attention is fixed by the inquiry, so important to the present interests of society: What is the cause of the general glut of all the markets in the world, to which merchandise is incessantly carried to be sold at a loss? What is the reason that in the interior of every state, notwithstanding a desire of action adapted to all the developments of industry, there exists universally a difficulty of finding lucrative employments? And when the cause of this chronic disease is found, by what means is it to be remedied? On these questions depend the tranquillity and happiness of nations.

Who do you think said that? As Petur Jonsson (1995) pointed out, it was Jean Batiste Say, of Say's Law. Keynes set up Say as the straw man of classical economics, in order to tear classical economics down, but the actual Say was a subtle writer who fully believed general gluts were possible. Another leading monetary economist of Keynes's time, Denis Robertson (1921), had a sequence model of the economy that arrived at Keynesian-type results, as did Lauchlin Currie (1934) in the United States. It is a textbook fiction, initially perpetrated by Keynes, that led us to the polar views of Keynesian economics and classical economics. Keynes wanted to differentiate his product, and he did so by painting classical economists as one-dimensional and believing in something that many did not believe in.

The reality is that classical economics had an extremely rich and varied tradition that included much, if not all, of what we currently present as Keynesian economics. In marketing his ideas, Keynes took that rich and varied tradition and pigeonholed it into a one-dimensional line of thought that he centered around Say's Law. As I argued in *The Coming of Keynesianism to America* (Colander and Landreth 1996, 15), in doing so, he unfairly characterized classical economics. Had Keynesianism not existed, much of what we teach as Keynesian economics would still be taught, only it would not be called Keynesian. Thus, the reason I oppose dumping Keynesian economics has nothing to do with dumping the Keynesian name. The reason is that, in dumping Keynesian economics, the profession is swinging the pendulum back too far toward an implicit assumption that the market solves all our problems and is leaving out another important pragmatic dimension of classical thought—the belief that serious problems can develop. For example, in the early 1930s, Frank Knight and A. C. Pigou were both supporting government works programs and deficit spending to expand the economy. Similarly Keynes supported public works programs before he wrote *General Theory*. Even the Austrian economist, W. H. Hutt, one of the strongest anti-Keynesians, wrote: "But once the persistent ignoring of 'classical' precepts had precipitated chaos, and insurmountable political problems obviously block the way to non-inflationary recovery, only a pedant would oppose inflation" (1979, 45).

Most classical economists did not believe that, *theoretically*, the market was the solution to our problems—that view only developed in the analytic revolution when economists became enamored of math. Most classical economists believed that, *practically*, the market was the best way to solve our problems. Generally, I believe that the classical view is right, as did Keynes. But it is not always the

case, and students need to be taught that. They need to be taught that the argument for leaving things to the market is an historical argument, not a theoretical argument. It is based on the importance of government failure, not the absence of market failure.

REASONS FOR NOT DROPPING KEYNESIAN ECONOMICS

Let me now turn to the reasons given for dropping Keynesian economics presented at the beginning of this article and explain why they should be disregarded.

1. As a guide to policy, the Keynesian model is wrong, but that view is based on seeing the Keynesian model we present to principles students as a mechanistic, rather than an interpretative, model. The interpretative Keynesian model does not say that deficit spending will always expand the economy. In fact, nowhere in *General Theory* will you find an argument that deficit spending is needed to keep the economy going.

As I pointed out in "Was Keynes a Keynesian or a Lernerian?" (1984), Keynes was strongly against deficits. Keynesian economics simply states that deficits may be helpful at times. And that, I think, is true. At times they may be. I am not the only one who believes that. In policymakers' minds, demand management policy, taken broadly and not as a tool of fine tuning, is alive and well in policy discussions. We are doing our students a disservice if we do not teach them the multiplier model upon which that view is based. If we are teaching what policymakers talk about, which is what I think we should teach, policymakers think that multiplier effects are important. Consider Japan's macro policy discussion in the late 1990s of tax cuts and spending programs. Clearly, policymakers still discuss macroeconomics in Keynesian terms.

What has been happening in the 1990s to our economy is not a contradiction of the Keynesian model, it is an example of it. For one thing, the price level is remaining constant even as the economy expands beyond what economists believed possible. Think back; the reason the Keynesian model was dumped was that the assumption it made about fixed prices over a range of output did not seem to hold. But if one looks at the economy today, it fits the assumption of the Keynesian model; and now that it fits, we are dumping it.

Even the expected surplus is consistent with the interpretative Keynesian model. Keynes emphasized the uncertainty in the economy and fully believed that expansions in consumer and investment spending could fuel a substantial boom. And that is what is currently happening. The expenditure function has shifted up quite independently, causing tax revenue to increase and thereby causing a budget surplus.

2. Empirically, multiplier effects are not very large. The evidence is ambiguous, especially if monetary and fiscal policy are thought of within a forward-looking expectational model. In such a model, the mere expectation of the policy can affect decisions and affect the economy, making it almost impossible to empirically measure what the actual effect of the policy is.

What should be deleted from the model is any underlying certainty about the

size of multipliers. That is why I favor teaching the interpretative, not the mechanistic, Keynesian model. The interpretative Keynesian model uses the multiplier model simply to suggest direction of policy effects, not to be interpreted literally. It is an exercise of the mind, not a model of the economy.⁶

If we do not teach the interpretative multiplier model, students are left with the story that the economy adjusts to shocks and never can experience unwanted booms or busts. That, in my view is not correct, nor is it what policymakers believe. All real-world econometric macro models have multiplier effects in them. For example, the DRI (Data Resources Incorporated) model is centered around demand equations and cost-plus markups and has an implicit multiplier of about 2. Why? Because that is the model that empirically best fits our economy.

Finally, let me turn to Barro's argument about the size of the multiplier in World War II. It is true that there were no significant multiplier effects beyond the initial spending of government, but the reason why is clear: The government imposed rationing and a whole set of programs, such as price controls, to stop the secondary effects, because it wanted to focus all the production toward the war effort.

3. The gravitation toward the natural rate argument also has a problem. Economists simply do not know what the natural rate is, if there is one. Consider our record. How many economists in the early 1990s predicted that in 1998 inflation would be less than 2 percent and unemployment less than 4.5 percent? Few. Let me present some economists' views from that period, emphasizing that these were generally held beliefs of economists, and the economists chosen are only examples. The first example is Robert Gordon who in 1994 advised the Federal Reserve Board that the natural rate was probably 6 percent and possibly as high as 6.5 percent. In 1995 he adjusted that to 5.5 percent and, when it went lower, lowered his estimate to 5 percent. Edmund Phelps was saying in 1994 that the natural rate was 6.5 percent; he lowered his estimate to 6 percent in 1995 and thereafter made no estimates for that record that I know of.⁷

My final example comes from articles by Stuart Weiner, vice president of the Kansas City Federal Reserve Bank. In 1993, he wrote:

estimates suggest that the natural rate of unemployment is currently near 6.25 percent and could move even higher depending upon the extent and persistence of structural disruptions. . . . Thus, the near-term inflation risk may be higher than generally perceived. (53)

Fact: The unemployment rate in 1993 was 6.5 percent at the time the article was written. Core inflation rate was about 3.2 percent in 1993 and fell to 2.7 percent in 1994.

In 1994, he stated that:

the natural rate is currently 6.25 percent. With the actual unemployment rate averaging 6.2 percent in the second quarter, this means that labor markets currently are operating at full capacity. (6)

Fact: The unemployment rate in 1994 was 6.1 percent at the time the article was written. Core inflation rate was about 2.7 percent in 1994 and 3.0 percent in 1995.

Not to be undone, he wrote in 1995 that the natural rate was 6.25 percent and stated:

I do not find the skeptics' arguments compelling. If I had to choose just one variable to help me forecast inflation turning points, it would be the unemployment gap. And that gap is signaling that concerns about future inflationary pressures are well founded. (24)

Fact: The unemployment rate in 1995 was 5.6 percent at the time the article was written. Core inflation rate was about 3.0 percent in 1995 and fell to 2.8 percent in 1996.

No further articles by Weiner on the natural rate appear in the *Federal Reserve Bank of Kansas City Economic Review*.

In 1999, unemployment is below 4.5 percent and inflationary pressures continue to subside. I want to reemphasize that Weiner was not alone; he was expressing the view, based on the best empirical evidence available, of the large majority of economists in the 1990s. Not surprisingly, most economists are now far more circumspect when talking about the natural rate. My question is: Do we really want to make a fixed natural rate the centerpiece of our presentation of macro?

4. The economy does not have cycles any more; we are on an upward growth path that will continue into the indefinite future. In response, I simply cite the recent Asian crisis. Was that an experience of economies on their natural rate growth path? No, it was a crisis of confidence that affected the economies and is causing recession in those countries.

I, for one, would not want to go on record as saying that the U.S. economy is recession proof. The reality is that there is a lot we do not know about the macro economy—generally, it is relatively stable, but because it is based on financial stability, and that is based on trust and expectations, the stability can change quickly.

CONCLUSION

There is a lot we do not know about the macro economy. We should not be embarrassed by that. The macro economy is complicated—very complicated—and it is not surprising that we have a poor record of predicting. Given that we do not know a lot, should we not be honest with our students and not present macro economics as understanding more than it does?

What concerns me about the direction of principles of economics textbooks in the United States is that, in the attempt to simplify, the authors are presenting economic knowledge as more certain than it is. In doing that they are giving up teaching the economic method, and instead, concentrating on teaching what the policy answers are. The truth is we do not know for sure what the policy answers are. U.S. economists did not predict the growth the U.S. economy is currently experiencing, and we have been horrendous in predicting which areas would grow.

In thinking about what to teach, there is another legacy that I think we can usefully gain from Keynes. Specifically, Keynes was well known for his changing

views. Hence the famous joke—if you have four economists, you will have four different positions, unless of course one of them is Mr. Keynes, then you will have seven different positions.⁸ This was true because Keynes was a pragmatist about policy, who drew his policy views from several different models. He was a student of Marshall, and he stated: “The theory of economics is a method rather than a doctrine, an apparatus of the mind, a technique of thinking which helps its possessor to draw correct conclusions” (Keynes 1921, v).

This quotation is the epitome of the Marshallian method. It tells us to use economics as an engine of analysis, not as a set of principles. If we keep that Marshallian method in mind, we will be giving our students a good foundation in understanding macroeconomics, and we will be treating Keynes the way he should be treated—as an economist who carried on an important tradition in classical economics.

NOTES

1. This tendency is most pronounced in Mankiw (1998).
2. Robert Barro (1996) argues this position most strongly, but it can be found in many intermediate texts such as Hall and Taylor (1997).
3. This view can be found in almost all intermediate and introductory textbooks. See either Mankiw (1998) or Hall and Taylor (1997) as examples.
4. Mankiw (1998) starts his introductory book with a presentation of long-run growth; in intermediate macro books, Hall and Taylor (1997) and Dornbush, Fisher, and Startz (1999) both have changed their presentation to emphasize the Solow growth model.
5. The term “coordination problems” comes from game theory and is based on the possibility of multiple equilibria. The economy will arrive at an equilibrium but it may not be the most desirable equilibrium. In macro what is meant is that expectational conundrums can develop that lead the economy to an equilibrium at other than the desirable output. See Colander (1996) for a further discussion.
6. For a further discussion of what is meant by interpretative model, see Colander (1998).
7. For a discussion of these and other economist’s predictions of the natural rate, see Amanda Bennett (1997).
8. As usual Keynes had a retort. When challenged for his inconsistency, he replied that when he was presented with new evidence he changed his mind, and then he asked what the questioner did when faced with new evidence.

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