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The Anti-Keynesian Tradition: Introduction

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VOLUME 2 THE ANTI KEYNESIAN TRADITION

Chapter 2: INTRODUCTION

Robert Leeson

The first volume of this trilogy examined the Keynesian Tradition; this second volume examines aspects of the Anti Keynesian Tradition. These chapters illustrate the argument that economists neglect at their peril the subterranean world in which our subject is constructed. Archival evidence provides numerous unique insights and can also resolve disputes that may otherwise meander along, endlessly. Equally, archival evidence can expose as hollow some of the creation myths and unflattering caricatures that pervade accounts of intellectual and policy revolutions.

Warren Samuels (chapter two) provides an analysis of the purposes to which archival research can be put, also drawing attention to the possibilities of an archival-based analysis of the First and Second Chicago Schools. Such systematic comparisons of Chicago Old and New are long overdue; they will doubtless provide numerous insights into the process by which Frank Knight, Henry Simon et al. had only marginal immediate policy impacts, but major 'second round' impacts (with 'long and variable lags') through their students, Milton Friedman, George Stigler and Allen Wallis. Archival research also illuminates aspects of the Third Chicago School: the rational expectations revolution of Robert Lucas et al. and the ongoing (but often unacknowledged) influence of Simon's 1936 JPE essay 'Rules versus Authorities in Monetary Policy'.

Ross Emmet (chapter three) provides an account of Frank Knight's three-decade-long attempt to write a textbook (1910s-1940s). In the end, Knight settled for a Chicago "local use" teaching supplement (although his mimeograph was finally published in 1951, apparently without his consent). The lack of a systematic effort to 'spread the gospel' did not characterize either the Second Chicago School or another of Knight's students, the Keynesian Paul Samuelson.

Enrico Sergio Levrero (chapter four) examines Friedman between his two stays at Chicago: his statements and writings during his period in wartime Treasury's Division of Tax Research. 'Washington Friedman' (1941-43) was different from the Friedman that emerged after his return to Chicago (September 1946), and somewhat horrified 'Autobiographical Friedman' (1998); yet there are distinct continuities. Friedman was embarrassed to have developed the system of taxation-at-source (with all the associated anti-libertarian implications); yet on April 16, 1946 (before his return to Chicago) Friedman referred to the supply of cash and bank deposits as "the basic causes of inflation".

J. Daniel Hammond (chapter five) explores the process by which Friedman came to write his famous and highly influential 'The Methodology of Positive Economics' (1953). The first draft was written in early 1948, as Samuelson was finishing his (subsequently best-selling) introductory textbook. Hammond argues that Samuelson was pushing economics

in a formalist direction, whilst Friedman (1946, 283) disparaged the agenda that, he believed, would trap economists in "formal models of imaginary worlds".

Thomas Gale Moore (chapter six) was a Chicago graduate student at a pivotal moment: the publication of Friedman's Studies in the Quantity Theory of Money (1956) and Theory of the Consumption Function (1957), Stigler's return to Chicago and the 'Coase conversion evening' all occurred around this time. Moore explains how this Chicago environment transformed him from "flaming socialist to flaming libertarian", and attributes this metamorphosis, in part, to the influence of Friedman's mimeographed microeconomics textbook.

Warren Young and co-author (chapter seven) describe the process by which Friedman obtained – from A.W.H. Phillips – the adaptive inflationary expectations formula that would later be used to undermine the Keynesian Phillips Curve. This chapter also argues that the role Phillips allocated to inflationary expectations in the theoretical Phillips Curve was far more damaging to macroeconomic stability than the role that Friedman subsequently allocated in his famous American Economics Association Presidential address. For Phillips, inflationary expectations were destabilising; for Friedman, they were stabilizing (as expectations are corrected, and the economy moved back to expectational equilibrium at the natural rate of unemployment). The archival evidence reinforces the textual evidence: the standard story by which Monetarism overthrew its naïve (static expectation) Keynesian adversary is mythical. Indeed, Phillips was aware of the limitations of the optimal control agenda and developed a Lucas-type critique before Lucas.

Michael Oliver (chapter eight) provides an insight into a Chicago article of price flexibility faith: the consequences of fixed exchange rates. One of the hardy perennials of British politics is the conflation of national strength with an overvalued exchange rate. Despite this national priority, both during and after this Sisyphean challenge, Sterling fell from US$4.03 to US $1.57 (1949-1976), falling again to US$1.05 in February 1985.

The costs of this loss-of-face obsession were widespread: the threat of revolution (the General Strike, 1926), imperial humiliation (Suez, 1956), and financial hemorrhage (Black Wednesday, 16 September 1992). In the first episode (the return to the Gold Standard at pre-war parity) the cost of a rigidly defended inappropriate price was borne by the coal miners (whose wages were seen – by the mine owners - as the only available equilibrating instrument). Scuttling from imperial misadventure in Suez (to protect Sterling) intensified ancient French suspicions about British reliability: Britain was thus only belated admitted to the European Economic Community – just as the post war boom gave way to stagflation. In 1992, the major cost was borne by the British Treasury and the housing sector (hit by high Sterling-rescue interest rates); the value to George Soros of this British obsession was over $1 billion.

Governments that overvalue the exchange rate have their economic competence appropriately valued by the electorate - typically resulting in periods of prolonged opposition. British Labour Governments were especially apprehensive of the electoral

taint of being ‘the party of devaluation’: one (by then a ‘National’ Government) left the Gold Standard (1931); two (1949 and 1967) presided over devaluation (a fourth, 1976, would later go cap-in-hand to the International Monetary Fund). The Conservative Party was also committed to exchange rate fixity (free market rhetoric not withstanding). In July 1967 Edward Heath referred to the case for flexible exchange rates as “bollocks”; in September 1970 he declined to be persuaded by Friedman in person. This chapter uses archival evidence to illuminate the pre-November 1967 devaluation and the pre-June 1972 float periods. During this episode, the fixers were overcome by Friedman’s heretical price flexibility solution.

Warren Young (chapter nine) examines the genesis and evolution of another Anti-Keynesian research program: the process by which Robert Lucas’s work and the Lucas Critique in particular, developed into the Kydland-Prescott real business cycle school. In their JPE article ‘Rules Rather than Discretion: The Inconsistency of Optimal Plans’, Finn Kydland and Ed Prescott (1977, 487) concluded that “policymakers should follow rules rather than have discretion”. Friedman (1967, 1) described Simons as “a shaper of my ideas”; and Kydland and Prescott are also implicitly members of Simons' “rules party”. Indeed, thirty years later, Prescott acknowledged the importance of Simon’s article after reading it for the first time: "Simons sees it as rules versus authorities. I see things very differently. An independent central bank, which is an authority or mechanism, is proving effective in sustaining a good monetary policy rule, namely price targeting … There are some ideas here. Maybe decentralized systems perform better because they better deal with the time inconsistency problem than do centralized systems. This requires a theoretical framework where the concept of decentralized is well defined. Better theory in the language sense of ‘theory’ is needed” (Prescott to Young, 19 February 2007). It would seem that even after seventy years, Simons' seminal published work is still relevant for theorists, despite having sunk into an archival-type subterranean world.

Fiorenzo Mornati (chapter ten) uses Vilfredo Pareto’s correspondence to explore the evolution of some of the ideas that became part of Chicago microeconomics. Pareto was a pivotal player in the second generation Neoclassical School: a ‘liberal’ (in the European sense), indeed a “liberalist militant”, who sought to provide solid theoretical foundations for “rational political economy”, minimal government action, free trade and “preference” based microeconomics. Diminishing marginal utility and measurable (cardinal) utility provided a foundation for income and wealth redistribution acording to the "greatest good to the greatest number" criteria. The ordinal utility revolution denied the legitimacy of such measurable interpersonal comparisons: its ‘victory’ in the 1930, provided the foundations of modern neoclassical microeconomics (the Coase conversion evening strengthened still further the Chicagoans faith in market outcomes).

There are similarities between the Paretian ordinalist revolution and the rational expectations revolution. Both revolutions sought to deny the validity of the intellectual justification for government intervention. Moreover, the consumer’s equilibrium connecting (subjective, preference-based) indifference curves to (objective) budget constraints has a parallel in the rational expectations equilibrium (which equates an

objective mathematical expectation with a subjective evaluation or expectation). Lucas (1976) focused on the microeconomic foundations of macroeconomics and argued that preferences were part of the "deep parameters" that should be modelled. Lucas, Prescott and Kydland sought to break the nexus between the macroeconometric models of the time and (discretionary) policy inferences, while Pareto sought to remove the connection between cardinal utility and utilitarian social welfare inferences. For Pareto, preferences were deep parameters and ordinal utility represented preference-ordering. Kydland and Prescott (1977, 479, 475) connected Phillips curves to indifference curves, concluding that with rational expectations the marriage of optimal control theory to aggregate demand management was “absurd”. Pareto claimed to have discovered a universal law of income and wealth distribution, an inter-temporal, pan-cultural constraint on policy interventions. Thus the New Classical Policy Ineffectiveness Proposition resembles the Policy Restrictivenss of Pareto Optimality and Pareto’s Law of Income Distribution.