

HET  
2019-2020

Seminar 2.1  
November 2019

**Economics after WWII:**  
**Econometrics and synthesis**

# J.M. Keynes (1883-1946)

- Father: J.Neville Keynes
- Cambridge
- Bloomsbury group,  
antiVictorian and bohemian  
(Virginia Woolf, E.M.  
Forster, Duncan Grant,  
Vanessa Bell)



# J.M. Keynes (1883-1946)



## **Theory of effective demand**

Investment: expectations (“animal spirits”)

Non-optimal equilibria

## **Criticism against neoclassical economics:**

the notion of equilibrium

rejects Say’s law

investment schedule

institutions and regulation

# 1. Keynes, the Great Depression and the first economic models

(1933) “The decadent international but individualistic **capitalism**, in the hands of which we found ourselves after the (1<sup>st</sup>) War, is not a success. **It is not intelligent, it is not beautiful, it is not just, it is not virtuous** – and it doesn’t deliver the goods. In short, we dislike it, and we are beginning to despise it.”

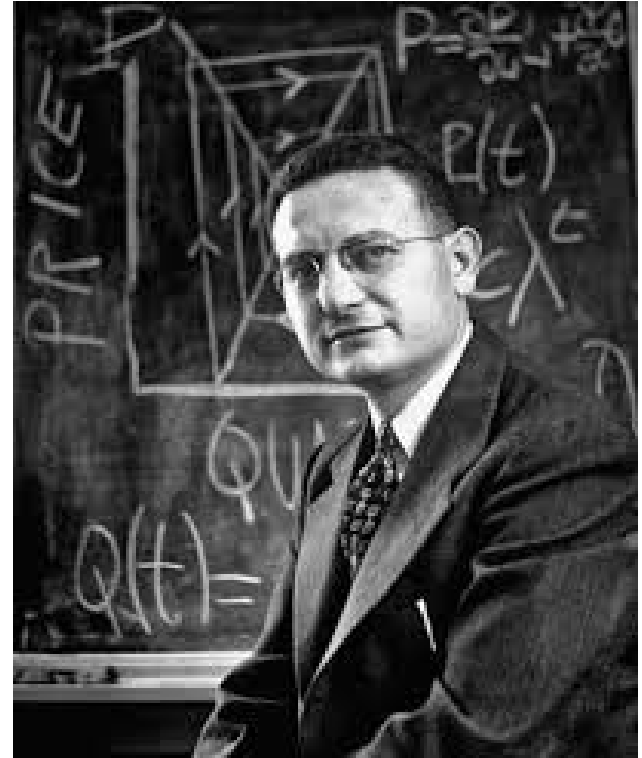
# 1936, **General Theory of Employment, Interest and Money**

- Concept of Marginal efficiency of capital
- Consumption function and the multiplier
- Equilibrium S and I, but still expectations
- Based on Marshallian short term comparative statics in economics
- The topic being not any more price adjustments (as in TM) but fluctuations of output

# The impact of *GT*

The *General Theory* “caught most economists under the age of 35 with the unexpected virulence of a disease first attacking and decimating an isolated tribe of South Sea islanders”

(Paul Samuelson)



# Lionel Robbins (1898-1984)



“I long realized that my earlier diagnosis of the Great Depression had missed the mark in not realizing sufficiently the paramount role played by the **catastrophic contraction of incomes brought about by deflation**”

The disciples:  
Roy Harrod (1900-1978)  
and J.R. Hicks (1904-1989)





# The puzzle of the IS-LM

- Hicks's interpretation
- 1937: Keynes's answer
- Harrod's strategy: to unify the efforts of the economists

# Oxford Conference, 1936

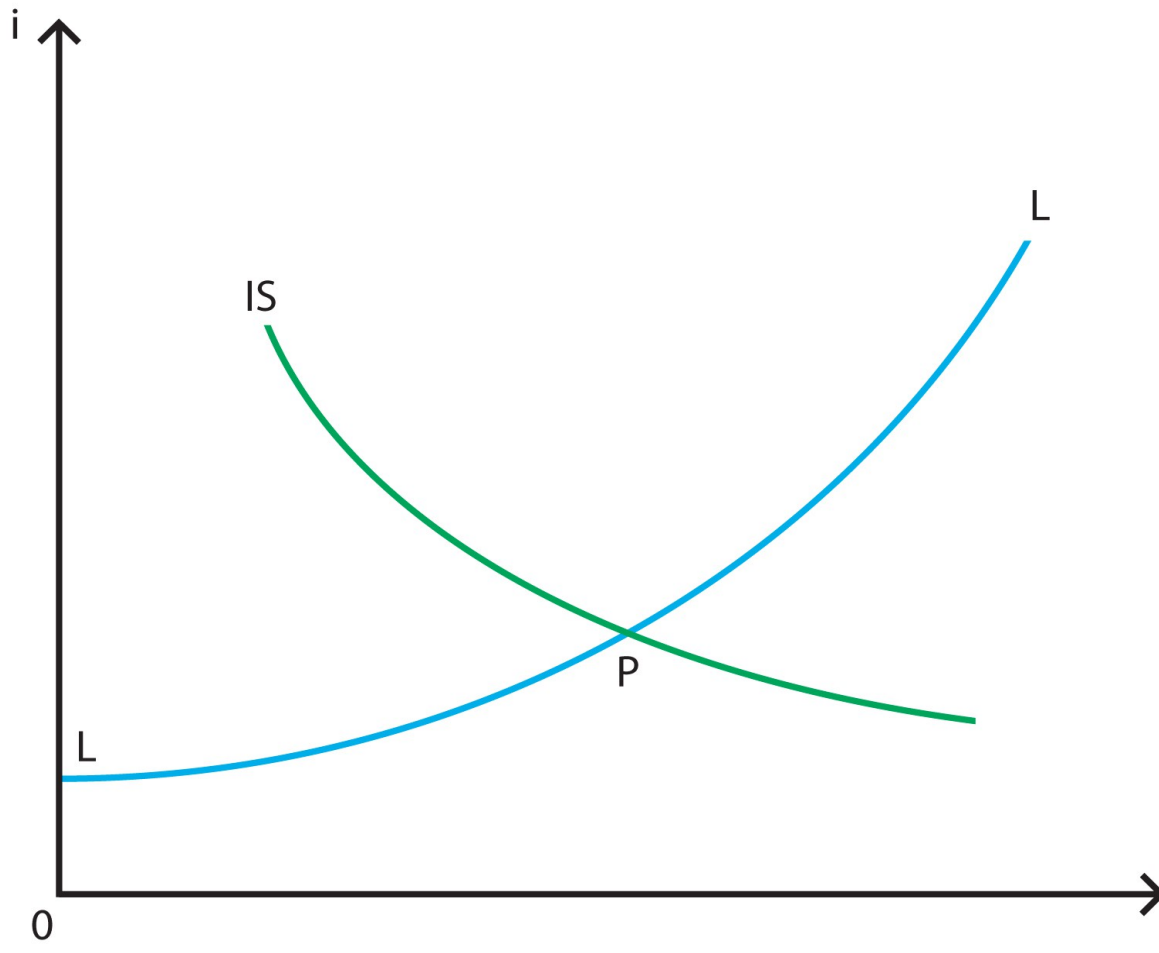
“It would be a good thing to ask one of Keynes’s adherents to explain to us **in a clear (i.e., mathematical)** way the substance of his new book (***Frisch: ‘excellent!’***) which now creates a sensation among English economists”.

(Marschak to Frisch, February 1936)

# Oxford, 1936

- Some of the disciples were absent (Joan Robinson, Shackle, Kahn), but Harrod was there
- “Hicks, Harrod, Meade and Hansen in America, the leading constructors of ‘IS-LM’ Keynesianism, had a clear motive: to **reconcile** Keynesians and non-Keynesians, so that the ground for policy could be quickly cleared. These early econometric models incorporated features which were not at all evident in the magnum opus, but which conformed more closely to orthodox theory.” (Skidelsky, 1992: 538)

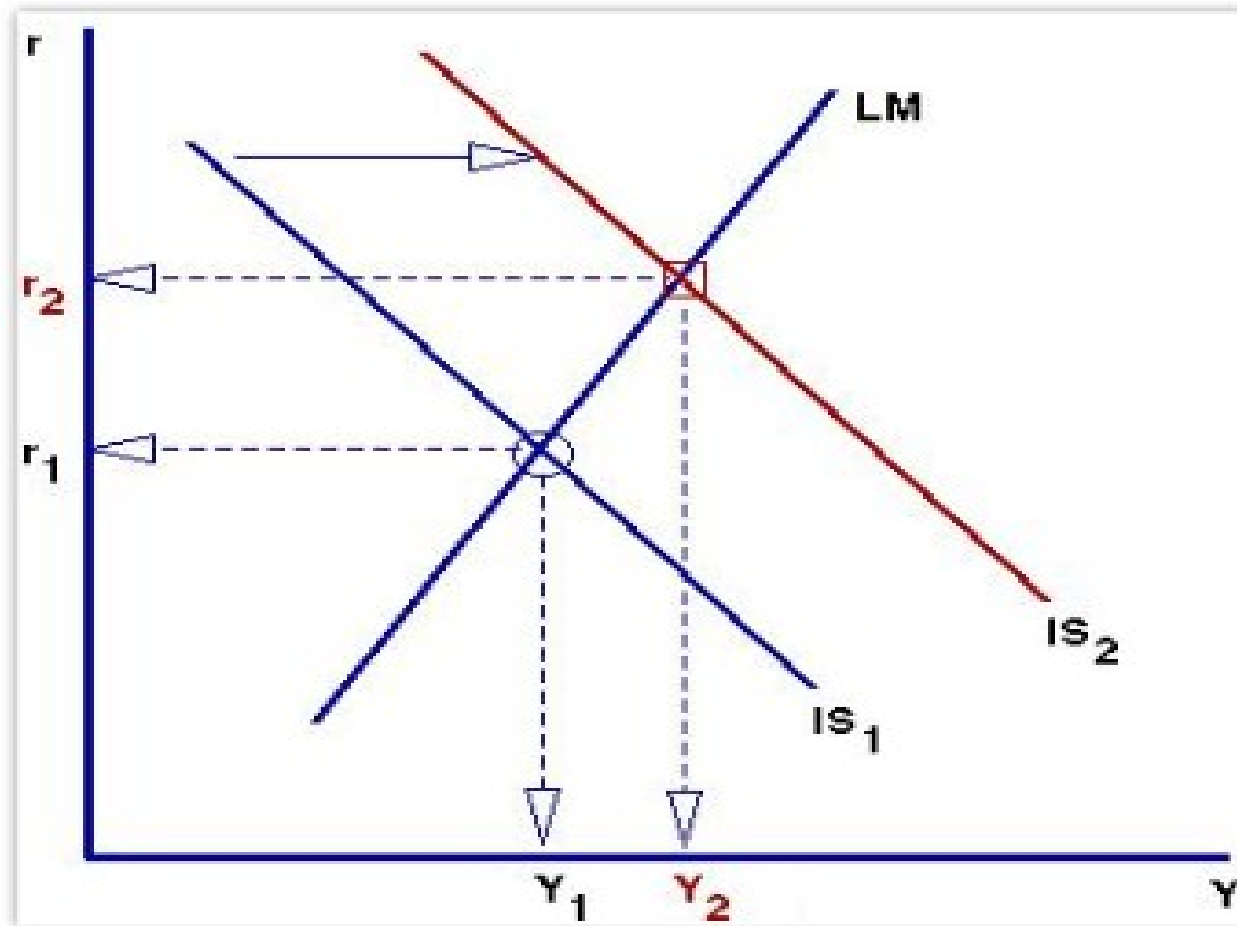
# Original version by Hicks (1937)



# The puzzle of the IS-LM

- Hicks's interpretation
- **1937: Keynes's answer**
- Harrod's strategy: to unify the efforts of the economists

# IS-LM model



# Roy Harrod vs Keynes

- **Harrod:** “My main endeavour was to **mitigate his attack on the ‘classical school’**. (...) It seemed to me that this was pushing his criticism too far, would make too much dust and would give rise to irrelevant controversies.”
- **Keynes:** “You don’t mention effective demand (...). To me the most extraordinary thing, regarded historically, is the **complete disappearance** of the theory of demand and supply for output as a whole, i.e. the **theory of employment**, *after* it had been the most discussed thing in economics.”

# Harrod on Keynes

- It is possible to return to the “great truths which Adam Smith preached” and to accept the “gospel, without sacrificing any of Keynes’ cherished principles relating to employment and trade depression” (**Harrod, 1951**)
- **Keynes**: “(Your) Freightful tendency to compromise”



# Late reply by Keynes

- 1) 1937, QJE: trajectories in time, uncertainty and choices of political economy
- 2) debate with Tinbergen on simultaneous equations, 1938 and 1939, then with keynesian econometricians and others (Marschak, Lange, Frisch, Divisia, etc.)

## ... and Hicks himself

- Exclusion of time and uncertainty
- Sequential and non-deterministic causality for Keynes whereas simultaneous and deterministic for IS-LM
- “(The IS-LM scheme) is now much less popular with me than I think it still is with many other people. It **reduces the GT to equilibrium economics**; it is not really in time. That, of course, is why it has done so well.” (Hicks, 1979: 289-90)

## 2. The econometric generation

- December 1930, foundation of the Econometric Society

I. Fisher   R. Frisch   J. Schumpeter



# The Econometric Society

An International Society for the Advancement of Economic Theory  
in its Relation to Statistics and Mathematics



*A l'occasion du centenaire de la naissance de*  
**Léon Walras**

*les membres soussignés de la Société Internationale d'Econométrie tiennent à exprimer  
leur reconnaissance à l'Université de Lausanne pour le service qu'elle a rendu à la  
Science, en dotant d'une chaire l'enseignement de la théorie de l'équilibre économique, et  
en lui imprimant un éclat qui a largement contribué à son rayonnement dans le monde.*

16 DÉCEMBRE 1934.

*Irving Fisher*

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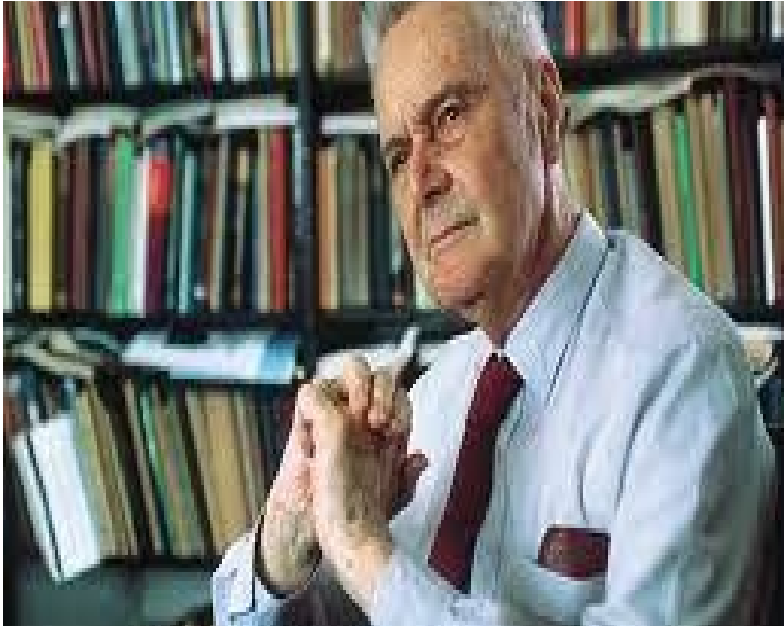
# Econometric Society

(created 1930)

# 1st conference of the Econometric Society (1931, Lausanne)



# The econometric debate



# The debate with Tinbergen:



Model of cycles: USA (1877-1913 e 1919-1932), UK (1871-1910), France (1871-1908), Germany (1871-1912)

Model USA: 22 equations, 31 variables, multiple regression and estimation by OLS

## **Critique by Keynes:**

- a) Complexity is irreducible to a model
- b) Non linearity
- c) Difficulty of specification and homogeneity through time
- d) Incomensurability
- e) Difficulty of analysing the qualitative results

# The Cambridge Conference, 1938

- Debate on Tinbergen (1939)
- Lange e Marschak try to publish a rebuttal of Keynes in the *Economic Journal*
- Memorandum by Frisch: it is not possible to estimate the causality relations



# The debate with Tinbergen: Keynes on probability



**Keynes on probabilities:** the degree of rational belief

**Keynes on frequencism and induction:**

“this view of basing probability upon series is certainly false. (...) My point is that the evidence need not always be of this nature and that in any case to base a statement of probability on a past frequency is not the same thing as to make a certainly true statement with regard to future frequency”

# Keynes against atomism

“The atomic hypothesis which has worked so splendidly in physics breaks down in psychics. We are faced at every turn with the problem of **organic unity, of discreteness, of discontinuity** – the **whole is not equal to the sum of the parts, comparisons of quantity fail us, small changes produce large effects**”

# The debate with Fridrieich Hayek



1931, the debate is ignited by a critique by Hayek against Keynes's *Treatise on Money*

On the notion of credit cycle, equilibrium, and the schedule of Savings and Investment

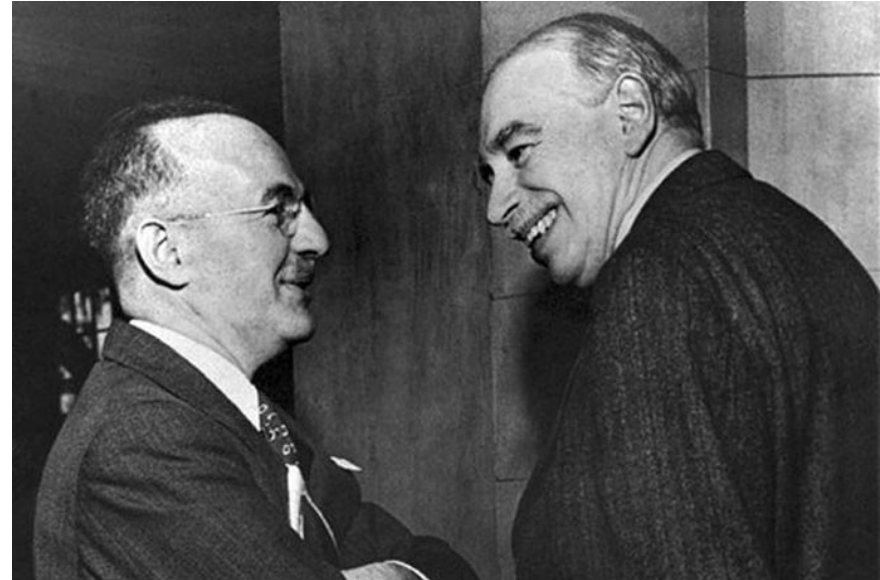
# The themes of the Hayek-Keynes debate

- Hayek: against explaining the cycle from the point of view of aggregate demand; for a self correcting mechanism of equilibration
- Hayek: the rise of  $S$  does not imply a reduction of total demand
- Hayek: intertemporal equilibrium, the cycle being a process of transition between equilibria

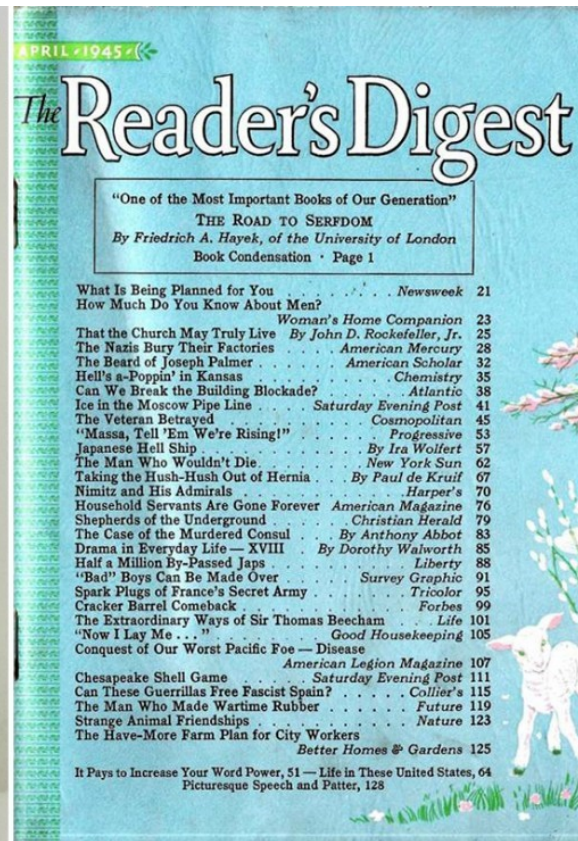
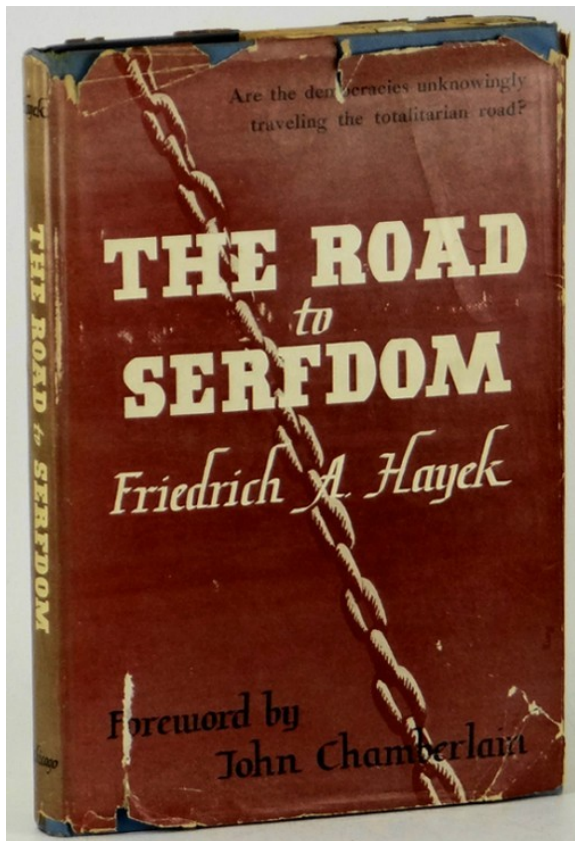
# Friedrich Hayek (1899-1992)

Debate with Keynes (1931) on the *Treatise on Money*, on the possibility of reducing unemployment by public spending and action (Hayek for private investment in public markets)

Keynes on “Prices and Production”:  
“**one of the most frightful muddles I have ever read**”,  
adding, “It is an extraordinary example of how, starting with a mistake, a remorseless logician can end in Bedlam” (a psychiatric hospital)



# Hayek's *Reader's Digest* version of *Road to Serfdom*



Road to Serfdom (1943), on the danger of Labour Party politics leading to totalitarian regime

# The creation of the Mont Pélérin Society

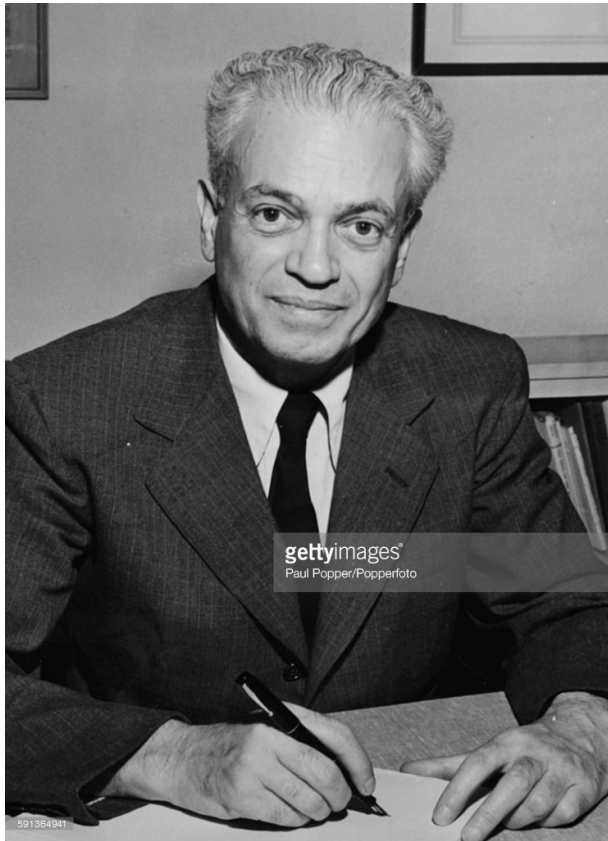


# Walter Lippmann (1938, Paris)





# Louis Rougier (Lippmann Colloque, 1938, Paris)



Louis Rougier: Lippmann Colloque 1938 (with 26 participants)

Secret conversations  
Pétain-Churchill

(not admitted in the MPS until the late 1950s)

# Mont Pélérin, 1947



**1947**

**Mont Pélérin, Switzerland**

**Friedrich Hayek**

**Karl Popper**

**Von Mises**

**Lionel Robbins**

**Milton Friedman (35 yrs)**



# Debates at the 1947 conference

- Rejected “conservatism,” associated with the status quo, but no alternative was clearly dressed; it gloried capitalism but not its cultural traits; it praised individualism but suspected democracy.
- Debate on the role of the Society: Indoctrination (Hayek) or pluralism (Popper)?
- For many years, the Society had scarce influence, except for Ludwig Erhard, chancellor of Germany (1963-1966)

# Lionel Robbins (1898-1984)



- Lionel Robbins, to treat the Russians as “though they are not human beings”
- The Cold War as a constitutive part of the Mont Pélérin endeavor

# Milton Friedman (1912-2006): monetarism against Keynesianism



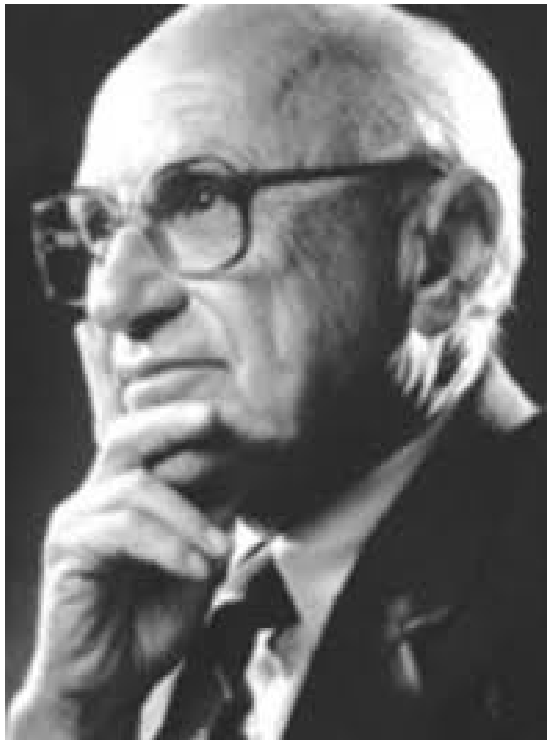
Demand led policy creates  
inflation

The reason for the 1929 crash  
was the wrong procedure of the  
monetary authorities

Monetary policy is the key

**Markets must be free to decide:  
laissez faire, laissez passer**

# Milton Friedman as a public man



1962, “*Capitalism and Freedom*”

abandoned programs of aid to the poor, argued for elimination of **agricultural price supports, minimum wage, military draft, national parks, public housing, social security**

borders open to all immigrants, although no social welfare

# The 1964 presidential debate

Friedman (and his candidate, Goldwater) strongly opposed to the civil rights legislation

But Friedman became a “public intellectual”



# The public intellectual

- Beginning in 1966 he published a successful column in the *Wall Street Journal* and in 1980 aired a ten-part TV series, "Free to Choose" on the public television network.

- **Milton Friedman choir:**

<https://www.youtube.com/watch?v=W3Seg0JE1PM>



# Conclusion

- **Keynes**: the dominant economist for the first half of the 20<sup>th</sup> century
  - Aggregate demand
  - Disequilibria
  - Psychological traits and institutions

The Keynesian-neoclassical synthesis: **Solow and Samuelson**

**Friedrich Hayek and Milton Friedman**: the new orthodoxy of the 1990s