Economists clash on shifting sands

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History is replete with famous intellectual battles. In the natural sciences, these have usually led to decisive victories, with good science ousting bad. There are few Ptolemaic astronomers left, or believers in the phlogiston theory of combustion. In the social sciences, the situation is different. There have been famous battles galore, but no decisive victories. Indeed, it is characteristic of the social sciences that their battles are interminable, temporary defeats being followed by the regrouping of the defeated forces for a renewed assault.

That economics is not a natural science is clear from the inconclusive engagements that have punctuated its own history. A hundred years ago the classical theory reigned supreme. This “proved” that free markets were automatically self-adjusting to full employment. They were either continually at full employment or, if disturbed by an outside shock, rapidly returned to it. The only thing capable of wrecking the workings of the market’s invisible hand was the visible hand of government interference.

Then along came the Great Depression of 1929-32 and John Maynard Keynes. Keynes “proved” that markets had no automatic tendency to full employment. This failing of the invisible hand justified government policies to maintain full employment.

For 30 years or so Keynesianism ruled the roost of economics – and economic policy. Harvard was queen, Chicago was nowhere. But Chicago was merely licking its wounds. In the 1960s it counter-attacked. The new assault was led by Milton Friedman and followed up by a galaxy of clever young disciples. What they did was to reinstate classical theory. Their “proofs” that markets are instantaneously, or nearly instantaneously, self-adjusting to full employment were all the more impressive because now expressed in mathematics. Adaptive Expectations, Rational Expectations, Real Business Cycle Theory, Efficient Financial Market Theory – they all poured off the Chicago assembly line, their inventors awarded Nobel Prizes.

No policymaker understood the maths, but they got the message: markets were good, governments bad. The Keynesians were in retreat. Following Ronald Reagan and Margaret Thatcher, Keynesian full employment policies were abandoned and markets deregulated. Then along came the almost Great Depression of today and the battle is once more joined.

Haunters of the blogosphere will know that the main ground of the current engagement is about the effect of the “stimulus”. FT readers will have caught a faint whiff of the intensity of this battle in Niall Ferguson’s column of May 30, headed “A history lesson for economists in thrall to Keynes”. Prof Ferguson and Paul Krugman, the economist and New York Times columnist, had previously locked horns at a public symposium in New York on April 30. The historian had asserted that large fiscal deficits would push up long-term interest rates. This implied they would have a zero stimulatory effect: public spending would simply “crowd out” private spending. An enraged Mr Krugman responded on his blog that Keynes had proved that such crowding-out could occur only at full employment: if there were unemployed resources, fiscal deficits would not drive up interest rates without also expanding the economy. Prof Ferguson’s ignorant remarks only confirmed that “we’re living in a Dark Age of macroeconomics, in which hard-won know-ledge has simply been forgotten”.

However, this is not a debate between economists and historians. It is a battle within the economic profession – between the New Class-ical Economists and the New Keynesians. What is fascinating is that it is an almost exact rerun of the debate between Keynes and the British Treasury in 1929-30. The Treasury view was that bond-financed public spending was bound to diminish private spending by an equal amount. Keynes replied that if this were true it would apply to any new act of private spending. “In short, the fatalistic belief that there can never be more employment than there is is altogether baseless”.

Later the Treasury retreated to a more defensible position. The danger of extra government spending, it came to argue, lay not in the “physical” crowding out of resources but “psychological” crowding out. If doubts arose about the government’s solvency – a concern Prof Krugman has acknowledged – it might lead to capital flight, which would push up the cost of government borrowing.

Are we doomed to rehearse the same arguments time and again? In this particular debate, I am on Prof Krugman's side, but I do not agree that Prof Ferguson's position represents a retreat to a phlogiston state of economics. This is to take economics to be like a natural science, which Keynes never believed it was, because he thought its subject matter was much too variable over time.

Keynes's view was that we need different economic models at different times. The beauty of his*General Theory of Employment, Interest and Money* was that it was general enough to accommodate a variety of models applicable to different conditions. Markets could behave in ways described by the classical and New Classical theories, but they need not. So it was important to take precautions against bad behaviour. Ultimately, the Keynesian revolution was a triumph not of good science over bad science, but of good judgment over bad judgment.

Lord Skidelsky's 'John Maynard Keynes: The Return of the Master' will be published by Allen Lane in September