

## REAL WORLD MACROECONOMICS: FINANCIAL MARKETS, LIQUIDITY, AND MONEY CONTRACT OBLIGATIONS

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Every well trained mainstream economist knows that the basic classical model (even in its Walrasian General Equilibrium format) is a description of an economic system where people make “real” decision and are not “fooled” by nominal values in their business and consumption decisions. In other words, a fundamental classical theory assumption is that money is neutral. But if money is neutral, financial market crashes in nominal terms should have no effect on the real economy since the marginal physical productivity of the underlying real assets are unchanged. Yet the Great Depression of the 1930s was preceded by a real estate monetary value market bubble and a stock market nominal bubble. Moreover, the Great Recession of 2007 - 2010 was preceded by a dot.com monetary bubble and a sub prime mortgage real estate bubble. How is this possible?

Keynes wrote his The General Theory of Employment, Interest and Money [1936] to explain why the fundamental postulates of the classical mainstream theory of his time are applicable to a “special case....[that] happen[s] not to be those of the economic society in which we live with the result that its teaching is misleading and disastrous if we attempt to apply it to fact of experience” [Keynes, 1936, p. 3].

To replace classical theory Keynes provided a general theory which explains the operations of a monetary economy where entrepreneurs enter into nominal contracts in order to organize production and exchange activities. [In mainstream macroeconomics, contracts are always made in real terms as no agent is suffering from “the money illusion.] The sanctity of

money contracts is the essence of the capitalist system in Keynes's GENERAL THEORY. This is an economy where money is never neutral – not in the short run nor in the long run, nor even if money wages and prices are either completely flexible or completely fixed by monetary forward contracts.

As I document in my book THE KEYNES SOLUTION: THE PATH TO GLOBAL ECONOMIC PROSPERITY, the founder of the American neoclassical synthesis Keynesian school, Nobel Prize winner Paul Samuelson, never understood Keynes's analytical framework. Accordingly, following Samuelson's lead, what was taught as Keynesianism after World War II in our most prestigious universities and almost all economics textbooks had nothing to do with Keynes's General Theory.

In an interview with Colander and Landreth [hereafter C-L 1996] Samuelson has indicated that even after reading the General Theory in 1936, Samuelson found the General Theory analysis “unpalatable” and not comprehensible [C-L, 1996, p. 159]. Samuelson finally indicated that “The way I finally convinced myself was to just stop worrying about it [about understanding Keynes's analysis]. I asked myself: why do I refuse a paradigm that enables me to understand the Roosevelt upturn from 1933 till 1937? ... I was content to assume that there was enough rigidity in relative prices and wages to make the Keynesian alternative to Walras operative” [C-L, 1996, pp159-160]. In other words, Samuelson merely assumed that Keynes had introduced price and wage rigidities into a classical Walrasian general equilibrium system! And Samuelson successfully propagate this incorrect view across the economics profession after World War II. So all mainstream Keynesian macroeconomics became a “special case” form of classical economics theory with short run price and/or wage rigidities that prevented a quick

recovery when a shock knocked the economy off its predetermined long run full employment path.

Apparently Samuelson never tried to comprehend Keynes's analytical foundation and framework. For in 1986 Samuelson was still claiming that "we [Keynesians] always assumed that the Keynesian underemployment equilibrium floated on a substructure of administered prices and imperfect competition" [C-L, 1996, p.160]. When pushed by Colander and Landreth as to whether this necessary requirement of rigidity of prices and/or wages for a Keynesian analysis was ever formalized in his work, Samuelson's response was "There was no need to" [C-L, 1996, p. 161].

Yet specifically in chapter 19 of The General Theory and even more directly in his published response to Dunlop and Tarshis, Keynes [1939] had already responded in the negative to this question of whether his analysis of underemployment equilibrium required imperfect competition, administered prices, and/or rigid wages. Dunlop and Tarshis had argued that the purely competitive model was not empirically justified, therefore it was monopolistic and administered pricing and wage fixities that was the basis of Keynes's unemployment equilibrium. Keynes reply was simply : "I complain a little that I in particular should be criticised for conceding a little to the other view" [ Keynes, 1939, p. 411]. In chapters 17 -19 of his General Theory, Keynes explicitly demonstrated that even if a purely competitive economy with perfectly flexible money wages and prices existed ("conceding a little to the other view"), there was no automatic mechanism that could restore the full employment level of effective demand in a money using , market oriented economy. In other words, Keynes's general theory could show that, as a matter of logic, less than full employment equilibrium could exist in a purely

competitive economy with freely flexible wages and prices..

Obviously Samuelson, who became the premier American Keynesian of his time, had either not read, or not comprehended, (1) Keynes's response to Dunlop and Tarshis or even (2) chapter 19 The General Theory which is entitled "Changes in Money Wages". In chapter 19 Keynes explicitly indicated that the theory of unemployment equilibrium "a rigidity" in money wages is not a necessary condition [Keynes, 1936, p. 257].

Keynes [1936, p. 259] indicated that to assume that rigidity was the sole cause of the existence of an unemployment equilibrium lay in accepting the argument that the micro-demand functions "can only be constructed on some fixed assumption as to the nature of the demand and supply schedules of other industries and as to the amount of aggregate effective demand. It is invalid, therefore to transfer the argument to industry as a whole unless we also transfer the argument that the aggregate effective demand is fixed. Yet, this assumption reduces the argument to an ignoratio elenchi."

An ignoratio elenchi is a fallacy in logic of offering a proof irrelevant to the proposition in question. Unfortunately Samuelson invoked the same classical ignoratio elenchi when he argued that Keynes's general theory was simply a Walrasian general equilibrium system where, if there is an exogenous decline in effective demand, rigid wages and prices created a temporary disequilibrium that prevented full employment from being restored in the short-run.

As Keynes went on to explain, "whilst no one would wish to deny the proposition that a reduction in money wages accompanied by the same aggregate effective demand as before will be associated with an increase in employment, the precise question at issue is whether the reduction in money wages will or will not be accompanied by the same aggregate effective

demand as before measured in term of money, or, at any rate, by an aggregate effective demand which is not reduced in full proportion to the reduction in money-wages” [ Keynes, 1936, pp.259-60, see also Davidson 1998]. Keynes then spent the rest of chapter 19 explaining why and how a general theory analysis must look at the relationship between changes in money wages and/or prices and changes in aggregate effective demand – an analysis that, by assumption, is not relevant to either a Walrasian system or Samuelson’s neoclassical synthesis Keynesianism<sup>1</sup>.

## KEYNES’S THEORY IS REAL WORLD MACROECONOMICS

In his The General Theory, John Maynard Keynes stated that classical economists

“resemble Euclidean Geometers in a non Euclidean world who, discovering that in experience straight lines apparently parallel often meet, rebuke the lines for not keeping straight – as the only remedy for the unfortunate collisions which are occurring. Yet in truth there is no remedy except to throw over the axiom of parallels and to work out a non Euclidean geometry. Something similar is required today in economics”

In this analogy comparing Euclidean geometry to classical theory, Keynes was alluding to the fact that in the classical analysis where the future is known, free markets are efficient since they produce full employment (the equivalent of the “parallel lines”). Yet significant and persistent unemployment (the “unfortunate collisions”) occur in the real world. Accordingly, classical economists rebuking the lines in the real world for not keeping straight is equivalent to blaming the victim workers for their unemployment problem because workers would not accept lower wages.

To create a nonEuclidean economics to explain why these unemployment “collisions”

occur in the world of experience, Keynes had to deny (“throw over”) the relevance of several classical axioms for understanding the real world. The three classical axioms Keynes threw over was (1) the neutrality of money axiom, the gross substitution axiom, and the ergodic axiom. The classical ergodic axiom assumes that the future is predetermined and can be calculated as the statistical shadow of the past by drawing a sample from the past and calculating the four moments around the mean. This ergodic presumption was the most important classical assertion that Keynes rejected.

It should be noted that the famous financial market participant George Soros has explained why the efficient market theory is not applicable to real world financial markets. In an article entitled “The Crisis and What To Do About It” that appeared in the December 4, 2008 issue of the New York Review of Books Soros wrote: “we must abandon the prevailing [efficient market] theory of market behavior”. Instead Soros insists that we should recognize that there is a direct connection “between market prices and the underlying reality [that] I [Soros] call reflexivity”. What is this reflexivity? In a letter to the Editor published in the March 15-21, 1997 issue of The Economist Soros objects to Paul Samuelson insistence on applying the ergodic axiom to economics because Soros argues the ergodic hypothesis does not permit “the reflexive interaction between participants’ thinking and the actual state of affairs” that characterizes real world financial markets. In other words, the way people think about the market can affect and alter the future path the market takes. Soros’s concept of reflexivity, therefore, is the equivalent of Keynes’s throwing over of the ergodic axiom.

In place of the rejected ergodic axiom Keynes argued that when crucial economic decisions had to be made, decision makers could not merely assume that the future can be

reduced to quantifiable risks calculated from already existing market data.

For decisions that involved potential large spending outflows or possible large income inflows that span a significant length of time, people “know” that they do not know what the future will be. They do know that for these important decisions, making a mistake about the future can be very costly and therefore sometimes putting off a commitment today maybe the most judicious decision possible.

Our modern capitalist society has attempted to create an arrangement that will provide people with some control over their uncertain economic destinies. In capitalist economies the use of money and legally binding money contracts to organize production, sales and purchases of goods and services permits individuals to have some control over their cash inflows and outflows and therefore some control of their monetary economic future. For example, households enter into contracts where they agree to pay rent, and contracts to pay for electric, gas, and telephone utility companies for providing services over time. These contracts provide the households with some cost control over major aspects of their cost of living today and for months and perhaps years to come. It also provides the other parties (business firms) to these money contracts with the legal promise of future current and future cash inflows sufficient to meet the business firms’ costs of production and generate a profit for providing the rental of the dwelling unit, and the utility services provided.

People and business firms willingly enter into nominal contracts because each party thinks it is in their best self interest to fulfill the terms of the contractual agreement. If, because of some unforeseen event, either party to a contract finds itself unable or unwilling to meet its contractual commitments, then the judicial branch of the government will enforce the contract

and require the defaulting party to either meet its contractual obligations or pay a sum of money sufficient to reimburse the other party for damages and losses incurred. Thus, as the biographer of Keynes, Lord Robert Skidelsky has noted, for Keynes “injustice is a matter of uncertainty, justice a matter of contractual predictability”. In other words, by entering into nominal contractual arrangements people assure themselves a measure of predictability in terms of their contractual cash inflows and outflows, even in a world of uncertainty.

Money is that thing that a government decides will settle all legal contractual obligations. This definition of money is much wider than the definition of legal tender that is printed on Federal Reserve Notes ( the paper currency of the United States) which is “ This note is legal tender for all debts, private and public”. These Federal Reserve Notes are liabilities of the Federal Reserve banking system.

For technical reasons regarding the banking system that we need not discuss here, the government permits the use of checks drawn on one’s checking deposit bank account as well as the tendering of legal tender currency to discharge any contractual obligations. In fact, readers will recognize that they pay most of their bills (contractual obligations) with checks drawn on their bank accounts, or, in this day of internet electronic banking, by sending an electronic message to their bank to take a sufficient sum out of their bank account to pay specific billers.

An individual is said to be liquid if he/she can meet all contractual obligations as they come due. For business firms and households the maintenance of one’s liquid status is of prime importance if bankruptcy is to be avoided. In our world, bankruptcy is the economic equivalent to a walk to the gallows. Maintaining one’s liquidity permits a person or business firm to avoid the gallows of bankruptcy.



We all are aware of our own need to maintain liquidity. This need for liquidity typically takes the form of making sure that each person maintains a positive balance in our checkbooks over time so that all contractual obligations can be met as they come due. If, in any month, we write so many checks that we are close to overdrawing our account, we typically solve this problem by either:

(1) stop writing checks until next month's income is deposited into our account, or

(2) we arrange for a bank line of credit where the banker agrees to replenish our bank balance if we should overdraw our account. In return we typically promise to pay the banker an interest payment and repay the loan principle out of our contractual future cash income, or

(3) we sell a liquid financial asset in our portfolio and use the money to replenish our bank account.

Obviously a negative check book balance is an economic disaster for all members of our capitalist economic system. But why should one desire to maintain a positive balance rather than a zero balance? Keynes's response to this query would be that since the future is uncertain, we never know when we might be suddenly faced with a payment obligation at a future date that we did not, and could not, anticipate and which we could not meet out of the cash inflows expected at that future date. Or else we might find an expected cash inflow suddenly disappears for an unexpected reason; for example because of a reduction in pension income due to financial market value declines, or a loss of job, or the death of the breadwinner in the family, or an asset that we held in our portfolio that we thought could easily be sold suddenly becomes illiquid or even worthless if, for example, this was a mortgage backed security that became a "troubled asset".. Accordingly we have a precautionary liquidity motive for maintaining a positive bank

balance in order to protect us from an unforeseen catastrophe. In a capitalist economy where we know the future is uncertain, enhancing our liquidity position to cushion the blow of any unanticipated events that may occur is an understandable human activity.

If individuals suddenly believe the future is more uncertain than it was yesterday, then they will try to reduce cash outflow payments for goods and services today in order to increase their cash liquidity position so as to be better able to handle any uncertain adverse future events since our fear of the future has increased. The most obvious way of reducing cash outflow is to spend less income on produced goods and services – that is to save more out of current income. If, however, many people suddenly think the future is more uncertain, then the cumulative effects of them all reducing their spending on the products of industry will result in a significant market decline for the output of business firms. Faced with this decline in market demand, businesses are likely to reduce hiring of workers.

In contrast, if markets in the real world were truly efficient, then households and business firms would have reliable knowledge of the future including their commitments regarding all future contractual cash inflows and cash outflows. Self-interested efficient decision makers, therefore, would never enter into a contract that requires a future payment obligation that they could not meet. No one would ever default on their contractual obligation. Consequently, there would never be a need for an additional liquidity cushion to meet an unexpected problem with one's cash flow balances. Yet in the real world, households and business firms, and even local (sovereign) governments do default on contractual obligations.

In fact, the sub prime mortgage crisis occurred because there was a significant rate of defaults on mortgages that had been packaged into mortgage backed securities that were sold “as

good as cash” to unwary savers. (In chapter 6 of my KEYNES SOLUTION [2009] book I explain why the default problems in sub prime mortgages created conditions that resulted in the financial crisis that exploded onto the global economy in 2008.)

Since efficient market theory, by assumption, eliminates the possibility of people defaulting on their contractual obligations, it should be obvious that this classical theory can neither logically explain what the relationship is between the sub prime mortgage problem and the global financial crisis that began in 2007. Nor can the efficient market theory provide any guidelines to resolve the problem, except to recommend leaving the problem to the free market to resolve, and in the long run the economy will right itself. In an estimate of the damage done by mortgage defaults it is said that perhaps more than a million people have been, or will be, thrown out of their homes. Those homeowners who remain in their homes will lose \$6 trillion of equity value in their houses. Can anyone seriously think that such a free market solution is socially desirable or even efficient? My good friend Alan Meltzer does since he often has told me that “bankruptcies are good for the health of the capitalist system.”

In a Keynes analysis, on the other hand, the civil law of contracts and the importance of maintaining liquidity play crucial roles in understanding the operations of a capitalist economy – both from a domestic national standpoint and in the context of a globalized economy where nations may employ different currencies and even different civil laws of contracts. In Chapter 8 of my 2009 book I show that flexible exchange rates are not the answer to persistent trade imbalances where trade transactions are organized via monetary contracts denominated in some nation’s money. For now, however, let us limit our discussion to the implications of domestic money and contracts for the domestic economy.

In Keynes's view, The sanctity of money contracts is the essence of the entrepreneurial system we call capitalism. Since money is that thing that can always discharge a contractual obligation under the civil law of contracts, money is the most liquid of all assets. Nevertheless other liquid assets exist that have some lower degree of liquidity than money since these other assets cannot be "tended", i.e., handed to the other party in a contract, to discharge a contractual obligation. Nevertheless, as long as these other assets can be readily resold for money (liquidated) in a well organized and orderly financial market, these other assets will possess a degree of liquidity. A rapid sale of the asset for money in a well-organized and orderly financial market will permit people to use the money received from the sale of these financial assets to meet their contractual obligations.

For examples, stocks traded on the New York Stock Exchange are not money. Nevertheless these securities are liquid because the Exchange has rules and institutions that are designed to assure the public that they can always buy or sell as much stock as they desire while also assuring the public that the market price will always change in an orderly manner. By orderly manner we mean that the price on the next sale of a stock transaction to be executed will not differ by very much from the price of the previous transaction. Thus when a person calls his broker and tells the broker to sell x shares "at the market", the seller knows that the price he/she will receive will not differ by more than a few pennies from the last announced market transaction price.

As Peter L. Bernstein, author of the bestseller Against The Gods [1996], has noted the existence of orderly financial markets for liquid assets encourages each holder (investor) of these securities to believe they can execute a fast exit strategy at any moment when they

suddenly decide they are dissatisfied with the way things are happening. Without liquidity for these stocks, the risks of being a minority stock holder (owner) in a business enterprise would be intolerable. Nevertheless the liquidity of orderly equity markets and its encouragement of fast exit strategies makes the separation of ownership and control (management) of business enterprises an important economic problem that economists and politicians have puzzled over since the 1930s. In fact, in testimony before the House Committee on Oversight and Government Regulation (on October 23, 2008 Alan Greenspan stated that he was surprised that the managers of large investment bankers were not protecting the interests of the owners of these corporations. This indicates that Greenspan does not understand how the existence of orderly liquid markets drives an important wedge between ownership and management. Since Greenspan is an advocate of efficient market theory, his surprise is due to the fact that his classical theory tells him that those who own the firm will either manage the firm directly or hire managers (workers) who, if they want to stay employed, will pursue the same self-interest objectives that the owners would pursue if the latter actively managed the firm. In other words in classical theory there can never be a separation in the decision making between owners and managers. In the real world, on the other hand, if I am a minority stock holder of any corporation and I do not like the way management has been operating, I will immediately sell my shares rather than attempt to fire the managers who, in my opinion, have made bad mistakes in the operation of the corporation.

As long as the future is uncertain, the price that liquid assets can sell for at any future date in a free market could vary dramatically and almost instantaneously. In the worst case scenario financial assets could become unsalable (illiquid) at any price as the market for that asset collapses (fails) in a disorderly manner.

To assure holders of liquid securities that the market price for their holdings will always change in an orderly manner, there must exist a person or firm in the market place called a “market maker”. The existence of this market maker assures the public that if, at any time, many holders of the financial asset suddenly want to execute a fast exit strategy and sell, while few or no people want to buy this liquid asset, the market maker will have the obligation to enter the market and purchase a sufficient volume of the asset being offered for sale to assure that the following market transaction prices of the asset will change continuously in an “orderly” manner from the price of the last transaction. In essence the market maker assures the holders of a liquid asset that they can always execute a fast exit strategy at a price not much different than the last price. In the New York Stock Exchange these market makers are called “specialists” .

### **A Penny Saved is a Penny Not Earned.**

In a money using, capitalist system, the fact that people recognize that the future is uncertain means that households and business firms will want to maintain a liquid position. To obtain a significant liquid position, therefore, typically people will try not to spend all of their cash inflows (money incomes) on the products of industry each week, month, or year. This unspent portion of money income we call savings. To carry these savings, i.e., contractual settlement power, into the future savers will use a variety of liquid “time machines”. These savings may be stored in the time machine form of money in the mattress, and/or positive balances in the savers’s bank accounts, and/ or in buying and holding in one’s portfolio a variety of financial assets such as stocks, bonds, or other financial assets that the savers believe have a high degree of liquidity since they are being traded in a well organized and orderly market. Unfortunately the market became disorderly for some financial assets known as CDOs (Collateral Debt

Obligations), and other exotic financial derivatives. The result was the financial market crisis that began in 2007.

At this point we should note, that any portion of one's income that is not spent on the products of industry must mean a lesser demand for the products of industry than what would be the demand if all the income was entirely spent rather some portion saved. Thus savings can have a negative impact on business profits and employment hiring by firms<sup>2</sup>

What creates jobs in a capitalist economy? Although government creates some jobs and hires workers, e.g., members of police and fire departments, the armed forces, teachers in public schools and universities, judges, et cetera, the majority of jobs are created in the private sector by business firms hiring workers. Recessions and depressions occur when firms are laying off large numbers of workers, while prosperity occurs when firms are making good profits and in turn are hiring almost everyone who is willing and able to work.

What determines whether firms hire or fire workers? Expectation of increasing sales provides the positive incentives for business firms to hire more workers to produce additional output to sell at a profitable price. If, on the other hand, business firms expect (or experience) declining sales that imply declining profit opportunities, then firms will reduce the number of employees they hire. In sum, changes in expected future contractual sales and orders will have a dominant effect on the hiring practices of private sector employers.

Consequently anything that causes a decline in total spending on the producible goods and services produced by a country's business firms tends to depress employment while anything that increases spending on producibles increases the profitability of business firms and the hiring of workers. Thus, contrary to Benjamin Franklin's saying that "a penny saved is a penny

earned”, it is only every penny that is spent on the products of industry that becomes a penny earned to be shared by workers, managers and owners of business firms.

An act of saving out of current income means that the purchases on the output of industry will be less than if the entire income was spent and nothing was saved. A penny saved can not be earned by business firms selling goods and services. Savings represent less profit opportunities for business to make a sale and therefore firms will hire less workers than otherwise. It therefore follows that if, in total, all buyers of products and services decide to spend less and instead increase their savings, then less profitable market demand will be available to businesses and therefore firms will offer less employment.

Of course the job destroying potential of some savers can be offset if, at the same time, other buyers decide to spend more than before and to even go into debt to increase their purchases of goods and services from business enterprises.

Who are these other buyers and why will they be willing to go into debt to spend more? Economists tend to identify four classes of buyers of goods and services produced by business firms. These are (1) households, (2) business firms investing in additional plant and equipment because they anticipate future sales to exceed their current capacity to produce, (3) government, including state and local governments as well as the federal government, and (4) foreigners who want to buy our exports.

Many nations look towards export-led growth to promote prosperity. Unfortunately not all countries can have exports growing more rapidly than imports – and this has led to large trade imbalances in recent decades. The Bretton Woods “Keynes Plan” would have dealt with this problem.



Let us concentrate on the first three categories of buyers.

Household purchases tend to be closely tied to income. If household income increases households tend to increase their purchases of goods and services, and if their income declines they tend to spend less. If the economy is in a recession or depression it is because some buyers of the products of private enterprise are, for whatever reason, buying less and fewer workers are being employed. Thus a recession is always associated with a decline in the total of all household income as some workers are fired and have to live on lower unemployment compensation, while other households who obtain part of their income out of the profit of firms find these sums are being reduced as the business firms experience lower sales receipts.

What about investment spending by firms? Classical theory asserts that if markets are efficient, whenever households save more, simultaneously business firms will borrow these savings and spend more investing in plant and equipment. Does the reader really believe if people are saving more and thereafter are buying less from business firms, then business firms, in face of this decline in market demand, would immediately invest more in additional capacity to enable them to produce more product?

If market demand is declining and firms are feeling the effects of recession, then managers are unlikely to purchase new plant and equipment when they already have capacity that has been idled by this decline in sales and orders. Even if interest rates are reduced significantly to make it inexpensive to borrow to buy new plant and equipment from firms that produce these capital goods, managers are unlikely to borrow in order to buy additional plant and equipment when they already have excess capacity. Business firms will start reinvesting in plant and equipment only after market demand has risen sufficiently so that firms believe that sales

will be pressing on existing capacity. Accordingly in a recession we cannot expect enterprise to increase their spending on investment.

Consequently, that leaves government as the only possible big spender to offset falling sales and profits. Unfortunately most state and local government spending is closely tied to their tax revenue base, and in a recession, these governments quickly experience a shortfall in their expected tax receipts compared to their existing budget. Accordingly in many states and municipalities the revenue decline means an immediate reduction in the provision of public services and the firing of government workers which only swells the ranks of the unemployed and reduces market demand for the products of industry even more.

In the current recession, one of the first expenditures to be cut by state and local governments is spending on public colleges and universities, community colleges, public schools, et cetera. The result is not only an increase in unemployment of highly skilled and educated workers but also a reduction in the quality of public education at all levels, thereby robbing our children of the opportunity to obtain a quality education. Local governments will also cut back or suspend investments in the infrastructure that make living in a community satisfying.

Accordingly, only the Federal Government can not only maintain, but actually increase spending on the products of private enterprise in a recession even if the government's tax receipts are declining as business firms and household incomes decline. Of course for the federal government to purchase more, while revenues are declining means that the government must finance these purchases by borrowing money, that is by increasing the annual deficit and therefore adding to the National Debt which at the end of 2008 already totaled \$10 trillion .

The Keynes Solution for recession and depression is to develop a recovery spending plan that may require significant to massive government expenditures. But these massive expenditures are not at all bad. Remember if this spending is used to buy the products of the nation's business firms, the result will be to create massive profit opportunities for American business firms who, in turn, will create a significant increase in the number of job hires in the private sector restoring prosperity to American households.

### **What should the government buy?**

When significant unemployment and idle capacity exists, increasing government expenditures will expand market demand creating profit opportunities for firms to expand output and hire more workers. Depending on the specific things government buys from private enterprise specific industries will have the incentive to expand output and employment.

Consequently, what things should government purchase? Obviously if the government buys things that improve the productivity and lives of its citizens, then these purchases will be very desirable. Thus President Obama has suggested an economic recovery plan that contracts with business firms to restore and improving the infrastructure that serves communities around the nation. The Obama plan would include spending funds to encourage private enterprise to develop alternative energy sources of energy, such as solar panels, windmills, hybrid energy efficient automobiles, et cetera.

Yet many in politics would object to spending significant sums on such projects. Often, the same political people who object to spending large recovery sums on things that can be useful to the civilian population, would not hesitate to spend similar sums to purchase from industry all sorts of military equipment. This latter policy of spending on military equipment is

often referred to as military Keynesianism and until now has been the main form of Keynes spending policy to be acceptable to conservative politicians.

Nevertheless ideological free market advocates tend to be opponents of a strong government spending recovery program. Typically three basic objections are raised to any large scale budget recovery program:

(1) If we increase the national debt we will cause the nation to go bankrupt. In this argument the analogue of government as a household is typically raised. We all understand that households that run up too much debt relative to their income ultimately face bankruptcy. If households can't deficit spend indefinitely, why should our government be able to?

(2) If we increase the national debt we will burden our children and our grandchildren with paying off this debt and they will suffer for our profligacy.

(3) The government spending is going to be financed by the government "printing money". This increase in the total money supply will create, if not immediately, some time in the foreseeable (certain?) future, a Great Inflation.

In my book [Davidson, 2009] I explain the fallacies in these three arguments but for now, with the U.S. economy in a deep recession in 2009 and the global economy falling into the same hole, the question should not be "Can we afford a Deficit Spending Recovery Program to restore profits, jobs, and prosperity to the U.S. economy?". The real question should be "Can we afford not to deficit spend enough to restore prosperity to the U.S. economy?" For if we do not pursue an active government spending recovery plan, then our children and grandchildren will face a dismal economic future with little prospects of jobs and earning decent incomes over most of their life even if they inherit a government with a smaller total national debt.

This generation owes it to future generations to actively build a persistently prosperous capitalist system where profit opportunities are readily available and all who want to work and earn a decent standard of living are given the opportunity to do so.

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## NOTES

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1. The particular proof that Keynes claimed was irrelevant was the classical assertion that a fixed and unchanging downward sloping marginal product curve of labor was the demand curve for labor and so that falling wages must increase employment. In chapter 20 of The General Theory Keynes specifically develops an “employment function” that is not the marginal product

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of labor curve and does not assure that aggregate effective demand is fixed.

What the marginal productivity of labor curve indicates is that if in response to an expansion of aggregate effective demand, private sector entrepreneurs hire more workers to produce an additional flow of output per period, then in the face of diminishing returns (with no change in the degree of competition), the rise in employment will be associated with a fall in the real wage rate. In other words, the marginal product of labor curve is, for any given the level of effective demand and employment, the real wage determining curve. For a complete analysis of this point see Davidson (1998) or Davidson (2002).

Note

2.. Classical theorists avoid recognizing this depressing effect of savings behavior by assuming that whenever any individual saves a dollar out of income, there is another buyer who simultaneously is borrowing that dollar in order to dissave, that is to spend a dollar more than that buyer's income.