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## KEYNESIAN APPROACH TO THE WORLD FINANCIAL CRISIS

**Key words:** Keynesian approach, neoliberalism, crisis, aggregate demand, stimulus.

The aim of the following research is the complex analysis of modern neo-Keynesian approach to the world financial crisis, which had negatively influenced the world economics.

The following investigation thematics and necessity of understanding the peculiarities of Keynesian principles and economical laws involves using several methods of scientific research: comparative and elemental analysis, logical synthesis, methods of comparison,grouping of data.

The research realization gave the possibility to see that the following is noteworthy. Many believe that the root cause of the current global economic crisis is the adoption of neoliberalism as the new orthodoxy following the collapse of the dominance of Keynesian economics in 1979. The theoretical foundations of the proposals of the Washington Consensus are the usual analyses advanced by neoliberal economic theory. According to this argument economies are in crisis because of impediments to the free operation of the market. The impediments came from the over inflated interventionist Keynesian state and its expansionary and redistributive policies that deform market data and signals. The solution, according to the neoliberal thinking is the withdrawal of the state from the economy and the reinstatement of the unhindered operation of the market.

Neoliberalism propagated further that the operation of the financial system should be liberated from the state grip and prerogatives and be left to the free operation of the market forces while the interest rate should be determined competitively. Moreover, the withdrawal of the state from the economy required the privatization of all the activities and enterprises that were state-owned and directed, the limitation to a minimum of all state regulations and adequate guarantees for property rights, opening of the economies to liberalise international trade, capital movements and financial activities including the market determination of exchange rate between currencies, and abolition of protectionism.

For over two decades, therefore, neoliberal philosophy turned the global economy into a headless chicken. President Reagan and Prime Minister Thatcher were the prime drivers of the neoliberal philosophy in the 1980s. However, there is a widespread debate regarding whether the neoliberal economic theory promoted development or hindered it especially since the onset of the current global financial crisis in mid 2007. At present many agree that the Washington Consensus and its neoliberal philosophy was a total failure. The neoliberal economic theory led to crises after crises and impoverishment of many both in developed and developing countries.

The financial meltdown caused by excessive greed and speculation and the virtual absence of any meaningful regulatory intervention proved that the free market economy does not have any mechanism to self correct itself. The Keynesian economic theory that markets do not have any automatic mechanism to self correct in the short run is incontestably true now as it was in the 1930s and subsequently.

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The global economic crisis has shaken the foundation of the free market consensus of the past two decades. Several countries including the United States have embarked on massive fiscal stimulus plans to rescue the financial and the real sectors of the economy. Barrack Obama's stimulus package of $878 billion approved by the government in February 2009 represents the biggest fiscal stimulus ever.

Some of the EU countries have moved beyond fiscal stimulus and nationalized some of their failing banking industries. The current responses of the governments across the globe on the global recession fully recognizes the Keynesian view that markets do not have any automatic mechanism to self correct and that government intervention is necessary to revive the economy. Analysts hope the famous New Keynesian economists such as Paul Krugman, Joseph Stieglitz and Greg Mankiw are behind Obama's stimulus package and advocate for more stimulus than less. The biggest fear at present is not that the stimulus is too big but that is it too little and hence many are not effective. If the multiplier effect fails to raise the current level of spending beyond the $2 trillion gap in the US consumer demand at present, the Obama stimulus plan may not rescue the US economy from the current recession soon.

Among the emerging economies, China has already begun a massive government spending programmes to compensate for the sharp decline in aggregate demand due to the contraction in global demand for the country's export. Keynesian aggregate demand management has once again become a critical policy instrument for both developed and developing economies.

So, let's consider the topic more profoundly.

Keynesian economics also called Keynesianism and Keynesian Theory is a macroeconomic theory based on the ideas of 20th century British economist John Maynard Keynes. Keynesian economics argues that private sector decisions sometimes lead to inefficient macroeconomic outcomes and therefore, advocates active policy responses by the public sector, including monetary policy actions by the central bank and fiscal policy actions by the government to stabilize output over the business cycle [19].

We should learn from Keynes to focus on the macroproblems ofour day. Today's problem is the financial crisis and the resultinggreat recession. Neither the standard Keynesian policies ofdecades past nor the monetary policy doctrine of recent yearsprovides useful solutions. Dynamic stochastic general equilibriumtheory is part of the crisis wreckage, but turning to old orto New Keynesian theory will be of little use. A balance sheetrecession requires that policy address the problems in the privatesector's capital as well as its income accounts. We need serioustheoretical work on problems of system stability using, forexample, agent-based methods. Monetary theory needs to developanalysis of processes in which intertemporal budget constraintsare violated. Network theory will be useful in that quest.

...today we have involved ourselves in a colossal muddle, havingblundered in the control of a delicate machine, the workingof which we do not understand. J. M. Keynes (1930) [7].

The most important lesson from the life and work of John MaynardKeynes may be that the macroeconomist should start from theimportant problems of the day and should face the followingquestions. (1) How are we to understand what is happening rightnow? (2) What can be done about it? What is the best policyto follow? (3) Do recent events force us to modify what, today,is widely accepted economic theory? If so, what is wrong andhow might we go about arriving at a more satisfying theory?

There are some things that Keynes would not have us do. He wouldnot have us try to deduce how the world works from a small setof doubtful 'axioms' about tastes and technologies.

Thus, wtat about understanding what is happening?

The important economic problem of today is the ongoing financialcrisis centered in the USA and the deepening world-wide recession.What might we learn from Keynes about it?

The current crisis developed in a manner quite contrary to thatpresupposed by Keynes in the General Theory.

The process leading up to today's American financial crisishad the dollar exchange rate supported by foreign central banksexporting capital to the USA. The Federal Reserve System hasnot had to defend the dollar (so far). On the contrary, thiscapital inflow was not even to be discouraged by a Federal Reservepolicy of extremely low interest rates. The price elasticityof exports from the countries that prevented the appreciationof their own currencies in this way kept US consumer goods pricesfrom rising. Operating an interest targeting regime keying onthe consumer price index (CPI), the Fed was lured into keepinginterest rates far too low for far too long. The result wasinflation of asset prices combined with a general deteriorationof credit quality [10]. This, of course, doesnot make a Keynesian story.

What then can we learn from Keynes that is relevant to the currentcrisis? The General Theory is not particularly helpful.

His various papersfrom the early 1930s are more focused on the financial crisisthan the General Theory where the notion has taken over thatthe real nexus of the problem is the coordination of householdsaving and business investment.

The Treatise on Money contains a piece of analysis that can befound illuminating. It deals with the financial side of a businessdownturn. Keynes assumes an initial equilibrium disturbed bya decline in expected future revenues from present capital accumulation.Firms cut back on investment and as activity levels declinedirect some part of cash flow to the repayment of trade creditand of bank loans. As short rates decline, banks choose notto relend all these funds but instead to improve their own reservepositions. Thus, the system as a whole shows an increased demandfor high-powered money and simultaneously a decrease in thevolume of bank money held by the non-bank sector. Keynes'spreference for speaking of 'liquidity preference'rather than 'demand for money' becomes understandablein this context since while an increase in liquidity preferencedoes constitute an increase in the demand for outside moneyit also leads to a decrease in the volume of inside money.

What makes this analysis relevant in today's context is thatit describes a process of general deleveraging as part of abusiness downturn. Causally, in Keynes's theory, it is the declineof investment expectations and the consequent contraction ofoutput that prompts deleveraging. Today, we are faced with theconverse problem where the deleveraging that the financial sectoris rather desperately trying to carry through has driven theeconomy into the worst recession since the 1930s. Only a yearago we were still treated to brave protestations from all sortsof sources that the real economy was strong and not much affectedby the credit crisis. Yet, it was quite clear that, in a closedsystem, it is a fallacy of composition to suppose that generaldeleveraging can take place without a decline in asset pricesand excess supply of goods and services in general [9].

Declining investment and increasing saving sounds like a textbookKeynesian recession. This is taking place, moreover, while agreat many agents are under severe liquidity constraints. Thefinancial conditions are such as to render the automatic adjustmenttendencies of free markets peculiarly ineffective in producinga recovery.

The great weakness of Keynesian income-expenditureanalysis is that it fails to deal systematically with the stateof balance sheets. This is a balance sheet recession. The troublestarts with the condition of private sector balance sheets,particularly of financial institutions, and this is the problemthat must be solved if the recession is to end any time soon.

Japan did try the kind of fiscal policies that were consideredconventional Keynesian economics some decades ago. Enormousamounts of money were spent on 'bridges to nowhere'and other, hopefully better motivated, projects until Japan'snational debt grew to a size that discouraged any continuationof the policy. All to little apparent avail.

So, the deficit spendingwill be absorbed into the financial sinkholes in private sectorbalance sheets and will not become effective until those holeshave been filled. If the sinkholes are large, this will takea long, long time. Today, they are enormous. Policy must addressboth the capital accounts and the income accounts [11].Nationalisation of the crippling losses of the financial sector—whetheror not the financial institutions are nationalised outrightor just 'bailed out'—is a precondition forold-fashioned 'Keynesian' stimulus to work.

There are two aspects of the wreckage from the current crisisthat have not attracted sufficient attention so far. One isthe wreck of what was, until 2007, the widely accepted central-banking doctrine. The other is the damage to the macroeconomictheory that underpinned that doctrine.

The real interest rate. In the old monetarism of Milton Friedman,the real interest rate was determined by real factors and couldnot be manipulated by the Central Bank. Any attempt to do sowould quickly destabilise the price level in Wicksellian fashion.This property was carried over into rational expectations monetarismand then into real business cycle theory and Dynamic StochasticGeneral Equilibrium (DSGE) theory in general. The Federal ReserveSystem under Greenspan put this proposition to the test in theyears following the dotcom crash, pursuing an extreme low interestpolicy. The result was more Keynesian than Monetarist and, asnoted, more Austrian than Keynesian: virtually no CPI inflation,but drastic asset price inflation and very serious deteriorationof credit standards [11].

For many years the main alternative to Real Business Cycle Theorywas a somewhat loose cluster of models given the label of NewKeynesian theory. New Keynesians differed from New Classicaleconomists in the extent to which they emphasised inflexibilitiesof prices or other contract terms as sources of short-term adjustmentproblems in the economy. Lately the two traditions have tendedto converge [20]. The New Keynesians have come toadhere to the DSGE modelling technology whereas the New Classicalsare incorporating various 'imperfections' of marketsto gain verisimilitude for their models. This convergence hasbeen labelled the 'New Neoclassical Synthesis'.

The Old Neoclassical Synthesis, which reduced Keynesian theoryto a general equilibrium model with 'rigid' wages,was an intellectual fraud the widespread acceptance of whichinhibited research on systemic instabilities for decades. Insofaras the New Synthesis represents a return to this way of thinkingabout macroproblems it risks the same verdict. The obvious objectionto this line of theorising is that the major problems that havehad to be confronted in the last 20 years or so have originatedin the financial markets—and prices in those markets areanything but 'inflexible'. But there is also a generaltheoretical problem that has been festering for decades withvery little in the way of attempts to tackle it. Economiststalk freely about 'inflexible' or 'rigid'prices all the time, despite the fact that we do not have ashred of theory that could provide criteria for judging whethera particular price is more or less flexible than appropriateto the proper functioning of the larger system. More than 70years ago, Keynes already knew that a high degree of downwardprice flexibility in a recession could entirely wreck the financialsystem and make the situation infinitely worse. But the pointof his argument has never come fully to inform the way economiststhink about price inflexibilities.

So, there are three things we should learnfrom Keynes. The first was to take our social responsibilitiesseriously and focus on the macroproblems of our own day. Today'sproblem is the ongoing credit crisis and its gradually unfoldingconsequences. The second was to try to understand what can bedone about it. The standard Keynesian policiesare not the answer. Neither is the central banking doctrinethat has dominated in recent years. The third was to ask whetherevents proved that existing theory needed to be revised. Onthat issue, it was concluded

that dynamic stochastic general equilibriumtheory as an intellectually enterprise has been bankrupted bythe crisis. However, like a zombie bank too-big-to-fail it willno doubt be with us for many years. This conclusion does notmean that we should revert to the old Keynesian theory thatpreceded it (or adopt the New Keynesian theory that has triedto compete with it). What we need to learn from Keynes, instead,are these three lessons about how to view our responsibilitiesand how to approach our subject.

Intellectual humility was not a character trait that his contemporariesnoted in John Maynard Keynes. He did not suffer fools gladlyand did not suffer many economists all that willingly either(perhaps the distinction sometimes escaped him). But he waswise enough to recognise that the complex system of a moderneconomy is ‘a delicate machine, the workings of whichwe do not understand’ and that ‘blundering’in the control of it can bring misery to millions and endangerthe social order. The economist of today has the tools to slaptogether a model to ‘explain’ any and all phenomenathat come to mind. The flood of models is rising higher andhigher, spouting from an ever increasing number of journal outlets.In the midst of all this evidence of highly trained cleverness,it is difficult to retain the realisation that we are confrontinga complex system ‘the working of which we do not understand’.Humility in the face of the reality we seek to explain is alsoa lesson to be learned from Keynes. That the economics professionmight be humbled by recent events is a realisation devoutlyto be wished.

Was it the Keynesian revival of 2008–2009?In the wake of the financial crisis of 2007–2010 the free market consensus began to attract negative comment even by mainstream opinion formers from the economic right.

In the United States and Britain. In March 2008, free-market guru Martin Wolf, chief economics commentator at the Financial Times, announced the death of the dream of global free-market capitalism. Shortly afterward economist Robert Shiller began advocating robust government intervention to tackle the financial crisis, citing Keynes [16].Macroeconomist James K. Galbraith used the 25th Annual Milton Friedman Distinguished Lecture to launch a sweeping attack against the consensus for monetarist economics and argued that Keynesian economics were far more relevant for tackling the emerging crises [6].The British Chancellor of the Exchequer referred to Keynes as he announced plans for substantial fiscal stimuli to head off the worst effects of recession, in accordance with Keynesian economic thought [17]. Similar policies have been announced in other European countries, by the U.S., and by China [15].

A renewed interest in Keynesian ideas was not limited to Western countries. In a speech delivered in March 2009 entitled Reform the International Monetary System, Zhou Xiaochuan, the governor of the People's Bank of China, revived Keynes's idea of a centrally managed global reserve currency. Dr Zhou argued that it was unfortunate that Keynes's Bancor proposal was not accepted at Bretton Woods in the 1940s. He argued that national currencies were unsuitable for use as global reserve currencies as a result of the Triffin dilemma - the difficulty faced by reserve currency issuers in trying to simultaneously achieve their domestic monetary policy goals and meet other countries' demand for reserve currency. Dr Zhou proposed a gradual move towards adopting IMF Special Drawing Rights (SDRs) as a centrally managed global reserve currency [1]. Dr Zhou's view was echoed in June 2009 by the IMFand in September was described by the Financial Times as the boldest statement of the year to come from China [5].

In an article looking back at 2009, economics professor Arvind Subramanian wrote in the Financial Times that economics had helped to redeem itself by providing advice for the policy responses that successfully prevented a global slide into depression, with the fiscal policy stimulus measures taking their "cue from Keynes" [2].

In 2009 there were several books published by economists advocating a further shift towards Keynesian thinking. The authors advocated further reform in academic economics, pol-

icy making and even the public's general ethics.Theoretical arguments regarding the relative merits of free market versus mixed economy policies do not always yield a clear conclusion.

On November 8, 2008, Paul Davidson and Henry C.K. Liu co-authored an open letter to world leaders attending the November 15 White House summit on financial markets and the world economy urging reconsideration of Keynes' analytical system that contributed to the golden age of the first quarter century after World War II. The letter, signed by many supporting economists, advocates a new international financial architecture based on an updated 21st century version of the Keynes Plan originally proposed at Bretton Woods in 1944. The letter ends by describing this new international financial architecture as aiming to create (1) a new global monetary regime that operates without currency hegemony, (2) global trade relationships that support rather than retard domestic development and (3) a global economic environment that promotes incentives for each nation to promote full employment and rising wages for its labor force [3].

With a few notable the Keynesian resurgence has been largely driven by policy makers rather than academic economists. Until very recently mainstream economists have not generally favoured robust counter-cyclical fiscal policies. While the school of thought known as New Keynesian economics has dominated the teaching of macroeconomics at universities, New Keynesians largely believed that monetary policy was enough to stabilize the economy, and largely rejected the case for interventionist fiscal policy which Keynes had advocated. Some economists (primarily post-Keynesians) have accused the New Keynesian system of being so integrated with pro-free market neo-classical influences that the label 'Keynesian' may be considered a misnomer.

Yet there has been a shift in thinking amongst many mainstream economists, paralleling the resurgence of Keynesianism among policy makers. The New York Times reported that in the 2008 annual meeting of the American Economic Association mainstream economists remained hostile or at least sceptical about the government’s role in enhancing the market sector or mitigating recession with fiscal stimulus - but in the 2009 meeting virtually everyone voiced their support for such measures [12].However a substantial shift in opinion is less obvious in the academic literature. Speaking in March 2009, Galbraith has stated that he has not detected any changes among academic economists, nor a re-examination of orthodox opinion in the journals [13].

The 2008 financial crisis has led some in the economic profession to pay greater attention to Keynes’s original theories. In February 2009, Robert Shiller and George Akerlof argued in their book Animal Spirits that the current US stimulus package was too small, as it does not take into account loss of confidence or do enough to restore the availability of credit. In a September 2009 article for The New York Times, on the lessons economists should learn from the crisis, Paul Krugman urged economists to move away from neoclassical models and employ Keynesian analysis. “So here's what I think economists have to do. First, they have to face up to the inconvenient reality that financial markets fall far short of perfection, that they are subject to extraordinary delusions and the madness of crowds. Second, they have to admit ... that Keynesian economics remains the best framework we have for making sense of recessions and depressions. Third, they'll have to do their best to incorporate the realities of finance into macroeconomics” [14]:

One more work is necessary to be considered.Keynes: The Return of the Master is a 2009 book by economic historian Robert Skidelsky. The work discusses the economic theories and philosophy of John Maynard Keynes, and argues about their relevance to the world following the Financial crisis of 2007–2010 [18].The author refers to Keynes's view that an over-reliance

on maths is a mistake, because mathematical models will always depend on the validity of their underlying assumptions. Skidelsky says that modern mainstream macroeconomics has become closely integrated with maths, at the expense of other disciplines such as political economy and history, and that this is partly why it became so unreliable at making accurate predictions or offering good advice. Various schools of thought within modern economics are briefly discussed, such as rational expectations, real business cycle theory and efficient market theory.Chapter 8 sums up Keynes's relevance to the current age as of 2009. The author suggests that Keynes would likely advise us to rethink macroeconomic policy, with a greater emphasis on balanced growth and with a somewhat large role for government in ensuring there is a smooth flow of investment to help protect the economy from unpredictable shocks. Macroeconomics should be reformed so that it again recognises the role of uncertainty and so it draws on other areas of knowledge such as history and International political economy, with a less central role for maths. The global savings glut needs to be addressed. Ethics should once again have a role in guiding capitalism, as should Keynes's vision of harmony, where differences are cherished rather than pressured to conform, as can be the case with current concepts of "social cohesion" and "consensus".

Thanks to the Great Recession, we're no longer talking about "rational expectations" or the "efficient markets hypothesis." Instead, it's all about stimulus packages, federal spending and G-20 summits. In other words, it's all about Keynes [4].

Thus, are we moving back to the Keynesian economic approach with all these bailouts around the world, or should we define a new paradigm for economics after the worldfinancial crisis has demonstrated the limits of the free market with its invisible hand?

The failure of economists, businesses and politics to predict and manage the recent catastrophic crash of the world's financial system has triggered a re-evaluation of the whole basis of current economic theories.

Since the end of the 20th century, economics has been dominated by the classical paradigm based on notions of rational consumers making rational choices in a simple supply/demand worldof finite resources, with prices constrained by decreasing returns; all driving the economy to an optimal equilibrium point.

So far, this classical economic approach, initially conceived by Adam Smith, has been working well. Indeed, in normal circumstances people are generally rational. The market automatically allocates resources and controls excesses in an optimum way with minimum oversight or outside regulation required. Under this model, the economy has been working as an equilibrium system; a system that moves from one equilibrium point to another, driven by shocks from external disruptions – technological, political, cultural etc- but always coming to rest in a natural equilibrium state.

But in extreme or complex circumstances, people and the system tend to behave/react differently including consumers, banks, financial institutions, stock market traders and governments. And perhaps the most critically flawed assumption of this classical model has been that economic agents are generally rational. Whereas, we observed recently insolvent households taking mortgages that they could not afford, banks lending to insolvent households without conditions etc. leading us to the subprime crisis …we know the result.

From this flawed assumption, the following question is raised: is it the theory that should be questioned or is it one of its hypotheses (namely the rationality)? Some would argue that questioning the hypothesis is questioning the theory. Anyway…

To tackle this current crisis, some voices have been suggesting more regulations as this would frame the rationality of economic agents and force them to behave in a more sensible

way; some others have been calling for more government intervention in order to set rules and monitor the whole system (with a big bailout here and there when necessary).

And would this mean going back to the Keynesianapproach of economics?

Indeed, according to Keynes, excesses or deficiencies in aggregate demand are the rule and not the exception. Therefore, for Keynes, government intervention is needed to eliminate recessionary and inflationary gaps: laissez faire, laissez passer policies should be replaced with an active interventionist policy by the central government. Keynesians believe that monetary and especially fiscal policies are required; otherwise disasters like the Great Depression that followed the First World War or the crisis that we are facing now would certainly reoccur.

Was Keynes right? Or is Keynes right?

Not so sure. If the Keynesian prescription for active government involvement in the economy was warranted after the World War I, in the past few decades, government intervention has become less desirable…and some argue, less necessary. Indeed, since the World War II, we have experienced six decades of growing competition. The once oligopolistic market structures in autos, telecommunications, services, etc. have become very competitive, and government policies increasingly have impact across borders. Furthermore, nowadays, banks, financial institutions, manufacturers, energy suppliers are increasingly internationally managed; following Keynesian policies with their fundamentally collectivist, centralized approach would just lead to more trouble. For instance, if a multinational that has networks over the world is centrally managed in the way Keynes suggests, the collapse of one element of the network in one country would easily make the whole system topple like dominoes around the world as we have just experienced.

In short, if the Keynesianapproach was likely to work after the First World War, the crash that we are facing now is far more serious than the Great Depression of 1929 as it can not be contained within borders or so easily solved by mass bailout, mass lending or big government investments/ job creation programs.

The need of an evolutionary or new economic model…

Instead of going back to the Lord Keynes School of thought, maybe we should rather think of a new model that would fit with the globalisation of markets, and that would -to some extent- set some global regulations to frame agent behaviours around the world, but ultimately leave the market free.

This new paradigm should be based on the principle that economies, markets, regulations, globalisation, as well as the internet (a new and very important component), consumers, enterprises and the brain all form complex adaptive systems in which agents dynamically and rationally interact, process information and adapt their behaviour to a constantly changing environment- but always reach a final equilibrium.

In this new model, and unlike the strict distinction between the too much and the too little government approach, the market should rather be a combination of an "invisible hand" and necessary regulatory elements (government that would not impede competition and risk) with the mindset that the market is henceforth a small village that needs to adapt to the constantly changing global environment.

To conclude this paper, it is strongly believed that free market still has a future, and markets are still perfectly self-regulating systems. They are only becoming enormously complex adaptive networks – too complex and interdependent for economists and governments to control or even understand.

The conclusions seem to be optimistic and even radical: we are all to become Keynesians now. However, as Keynes himself agrees, in the long run, the market forces will drive the econ-

omy into equilibrium, if the government takes appropriate actions to correct the short run fluctuations through appropriate macropolicies. Price still provides the best signal in resources allocation if greed and speculation are minimized and adequate levels of regulatory measures are instituted.

Capitalism has survived numerous booms and busts since 1690s, and 122 recessions in 21 advanced countries since 1960 alone. With economic policies based on Keynesian principles of demand management, capitalism will survive many more business cycles to come.

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