Keynesian Misjudgments About Strikes and Inflation

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Old Keynesian economics fell from favour, in part, because of the collapse of the Phillips curve trade-off; and in part because incomes policies usually failed to provide an ongoing restraint to inflation and industrial disputation. *The Search for a Wage and Price Policy* came to be seen as a "melodramatic old movie played again and again to a progressively more bored and irritated audience" (Neil Jacoby, cited by Goodwin 1975, 388). Monetarism, in contrast, empowered policy-makers with a simple faith in the ability of monetary targeting to control inflation. Some North American New Keynesians are currently showing signs of making judgements about inflation which are similar to those which led to the monetarist decade (Ball, Mankiw and Romer 1988; Blinder 1988, 282; but see Leeson 1994b, 1994d). This paper, therefore, provides an historical perspective to an issue of contemporary policy significance.

Two pivotal Keynesian misjudgments served, in combination, to curtail the attractiveness of Keynesian policy proposals. The first was Alvin Hansen's misjudgment about the relationship between strikes and inflation (his third intellectual *volte face*). The second was Paul Samuelson's misjudgment about the importance of inflationary expectations for Phillips curve analysis. By downplaying the importance of expectations in periods of inflation, Keynesians became powerless to prevent policy-makers from formulating disinflation packages which relied almost exclusively on the potency of self-destructing delusions about inflationary expectations - despite evidence of a profound asymmetry (Leeson 1997a).

Alvin Hansen's first intellectual *volte face* relates to his conversion to Keynesian economics (between 1936-38), after initially being highly critical (Barber 1987). Henceforth, Hansen became the American Keynes, and he was extraordinarily influential in that role. The second *volte face* relates to Hansen's transformation with respect to the costs and benefits of ongoing inflation. From around 1948, he recanted his former opposition to inflation (Leeson 1997b, 1997c). The third transformation, discussed below, is related to the first two, and is concerned with the connection between strikes and price inflation.

Keynes was aware that democracy placed a constraint upon policy-makers as the wage earner exercised an influence at the polls. He was concerned to improve standards of living through methods other than a damaging wage inflation. He also noted that "the main *raison d'être* of a trade union as a corporate body is gone if the perpetual struggle for higher wages is to be abandoned" (JMK XX [1930], 13). In 1921, in the *American Economic Review*, Hansen analysed North American data from 1881-1919. His hypothesis was that there was likely to be a fairly close correlation between strike activity and price movements.[1] (Movements in the price series were assumed to be a proxy for the business cycle). Hansen (1921, 619, 620) concluded that "Strikes correlate inversely with the business cycle in periods of long-run falling prices, while they correlate directly with the business cycle in periods of long-run rising prices".

Before the Second World War, Hansen was a committed opponent of ongoing inflation. If inflation, or deflation, were associated with increasing industrial disputation, this provides an additional reason for pursuing zero inflation. But after the War, fear of industrial disputation led him to relax, and then abandon, his commitment to zero inflation. Some degree of post-war inflation was the only *alternative* to widespread industrial disputation: "It would be suicidal to engage in destructive industrial conflict over the wage question" (1945, 260); "Blind adherence to a doctrinaire and inflexible pursuit of mere price stability will not do" (1945-6, 694). Thus price inflation - previously associated with increasing disputation - was now perceived to be an *antidote* to industrial disruption.

Alvin Hansen was a remarkably prolific and agile economist who should be applauded for his ability to change his mind. He was the antithesis of Samuelson's (1976, 382, 386) straw professor: "It is a sad fact about many scholars that they learn and unlearn nothing after the age of 29, so that there exist in chairs of economics around the world many economists who still live mentally in the year 1938". But when Samuelson went on to note, in this essay entitled 'Monetarism Objectively Evaluated', that "there is simply no excuse for living in a 1938 dream world in which money does not matter", this was, in a sense, a criticism of the implicit implications of Hansen's enormously influential Fiscal Policy Seminar. Certainly, Friedman and Schwartz (1982, 207) were able to point to Hansen's views on money as the thesis from which they derived their antithesis.

Hansen (1952) also believed that Keynesian policy was "just as applicable for inflationary problems as it is for deflationary problems ... In World War II the countries that most successfully coped with the war inflation attacked the problem in terms of Keynesian analysis". Later, another Cambridge economist, J. K. Galbraith (1987, 266) noted that the neglect of the political asymmetry with regard to the control of inflation and disinflation, ultimately facilitated the monetarist counter-revolution: Keynesian economics offered "a pleasant and easy downhill passage [higher public expenditure, lower taxes] but a very difficult and uncertain effort in ascent".

Keynes constructed the policy recommendations of *The General Theory* in opposition to the nominal wage cutting that had spawned the General Strike. His 'middle way' sought to reduce class conflict by pursuing more acceptable levels of employment by means other than a direct assault on money wages. The 'enemy' were the 'policy generals' who appeared determined to bring to industrial relations the same mentality that had threatened civilisation both during and after the First World War. But the enemy were only a problem in so far as they were deluded: "And over against us, standing in the path, there is nothing but a few old gentlemen tightly buttoned-up in their frock coats, who only need to be treated with a little friendly disrespect and bowled over like ninepins. Quite likely they will enjoy it themselves, when once they have got over the shock" (JMK IX [1929], 125).

In 1926, Keynes' feelings, if not his judgement, were with the striking workers. But in the judgement of one of Keynes' biographers, the Keynesian years of high employment and pro-union legislation enabled trade unions to be revenged for the perceived injustices of the inter-war years (Skidelsky 1992, 251). The vehicle for this vengeance was the strike weapon, which increasingly - to use Keynes' phrase from *How to Pay for the War* - allowed wages to "pursue prices with not so lame a foot".

Inflationary expectations rapidly became incorporated into wage negotiations. In 1957, Milton Friedman wrote to Raymond J. Saulnier, stating that incomes policies were "not only analytically wrong but politically dangerous" (cited by Gordon 1975, 116). Gradually, the Quantity Theory of Money was combined with inflationary expectations to transform, and effectively destroy, Keynesian Phillips curve analysis. Friedman (1966, 1968) fatally compromised the original Phillips curve trade-off by applying adaptive inflationary expectations analysis - which had been derived from Phillips (Leeson 1994c, 1997b).

As early as 1960, Friedman outlined, in full, the Natural-Rate Expectations Augmented Phillips (N-REAP) curve model to Richard Lipsey, and also to his students at Chicago (Leeson 1997b). Saulnier (1963, 25-27), a policy-influential economist of the period, also formulated a version of the N-REAP model. The following year, Alvin Hansen (1964, viii, 679) published a study of the business cycle, on the eve of "an exciting new venture ... Discretionary adjustment of tax rates to stabilise the cycle could go a long way towards shifting the so called modified Phillips curve downwards". Hansen (1964, 342-3, 288), discussing "misguided expectations" and the "objective causes of the cycle", concluded that "Keynes, following English tradition, perhaps overstresses errors of optimism. Even though there were no errors of optimistic expectations, the boom would nonetheless develop and subsequently die away if changes in technology led to intermittent surges of growth in capital formation ... In the end it is cold objective facts that control, not simply psychological moods of optimism and pessimism. The hour of reckoning comes sooner or later".

Sometime in that academic year (1964-5), Paul Samuelson pondered before a blackboard about the consequences of inflationary expectations for the Phillips curve trade-off; but for reasons that are not altogether clear, he remained unconvinced about the implications for Old Keynesian economics (Akerlof 1982, 337-8). This must be regarded as a poignant moment in Keynesian fortunes; a fatal misjudgment similar, in its consequences, to that provided by Hansen on the question of strikes and inflation.

The 1964 United States tax cut appeared to validate the tools (especially the multiplier) of the Keynesian revolution, and also the judgements of its modern advocates. A picture of Keynes was placed on the front cover of *Time* magazine. In one important sense, the pyrotechnics of *The General Theory* (which Keynes rapidly came to regret) did a great disservice to economics by validating, if not creating, a 'Year Zero' mentality in which subtle inter-war analysis of business cycles could be caricatured as either 'measurement without theory', or as the blind adherence to Say's Law. Many macroeconomists are still prepared to take on trust (and to teach to students) assertions about the "classical" economists which are palpably untrue. It would be tempting to describe the Chicago defeat of Old Keynesian economics as 'Pigou's revenge'; were it not for the fact that Pigou's work attracted unfavourable attention from Chicago (Knight 1924; Coase 1960).[2] Pigou invented the concept of "involuntary" unemployment, twenty years before *The General Theory*; he was a leading opponent of the 'Treasury view'; he advocated state manipulation of aggregate demand for labour to reduce unemployment; he also outlined an employment multiplier several years before Richard Kahn (Leeson 1996a).

But the Keynesian Phillips curve trade-off is not a concept that should taint the reputations of either Keynes or Phillips (Leeson 1996b). Neither had any toleration for the notion that ongoing and non-trivial rates of inflation would purchase sustainable reductions in unemployment. It was unfortunate that Keynesian economics became associated with this perception. During this current period of Keynesian renaissance, an appreciation of these episodes may assist in the formulation of unemployment-reducing policies which do not rely on such wishful thinking about inflation; or on such mischievous Molochs about the work of inter-war students of business cycles.

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Notes

1 Displaying the pre-Popperian strategy of the times, Hansen (1921, 619) wrote that "an effort was made to verify the above hypothesis".

2 Strictly speaking, Coase moved to Chicago in 1964 (Blaug 1985, 37).

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