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Steve Keen's The New Economics: A Manifesto

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CAPITAL AS POWER

No. 2021/07

Steve Keen's The New Economics: A Manifesto

Shimshon Bichler and Jonathan Nitzan

December 2021

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Steve Keen's *The New Economics: A Manifesto*

Shimshon Bichler and Jonathan Nitzan[1]

Jerusalem and Montreal
December 2021

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Steve Keen's book, *The New Economics: A Manifesto* (2021), offers a new path for economics, and for good reason. In his view, neoclassicism, the paradigm that rules modern-day economics, has become a serious menace:

> I regard Neoclassical economics as not merely a bad methodology for economic analysis, but as an existential threat to the continued existence of capitalism – and human civilization in general. It has to go. (155).

Strong words? Of course, but they are wholly warranted. Neoclassical economics is the official scientific underpinning of capitalism as well as its main ideological defence, and according to Keen, it fails in both tasks. Contrary to received opinion, neoclassicism *cannot* explain capitalism – either in detail or in the aggregate – and the policies it prescribes do not support but *undermine* the very system it defends. It must be scrapped, says Keen, and the purpose of his book is to explain why and outline what should come in its stead.

Half a century worth of research and writing on the subject has made Keen one of the world's foremost critiques of neoclassical economics. His previous bestseller, the rigorous-yet-accessible *Debunking Economics* (2011), dismantled neoclassical microeconomics. His new volume hammers its macro framework.

The book focuses on three key issues: (1) the bizarre neoclassical perspective that money, credit and debt do not matter for the macroeconomy; (2) the neoclassical insistence that the economy's complex, nonlinear turbulences are best explained in linear, self-equilibrating terms; and (3) the fact that neoclassicists have hijacked the economics of climate change, using patently false assumptions to justify do-nothing policies with untold future consequences.

1. Economics sans Money

Everyone knows that capitalism is about money, that credit is king, and that debt is everywhere. Or perhaps we should say, everyone except neoclassical macroeconomists. In their view, money, credit and debt, although prevalent, don't really matter.

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[1] Shimshon Bichler and Jonathan Nitzan teach political economy at colleges and universities in Israel and Canada, respectively. All their publications are available for free on *The Bichler & Nitzan Archives* (http://bnarchives.net). Work on this review was partly supported by SSHRC.

To backtrack a bit, economists, both orthodox and heterodox, divide the economy into two separate realms – real and nominal. The more important of the two is the real sphere. This is where you find what economists think really matter: production, capital and labour, technical knowhow, goods and services, consumption, wellbeing, utility and exploitation. The nominal sphere is about money, prices and finance, including credit and debt, and this sphere is deemed secondary. Metaphorically, the nominal sphere is like a giant mirror, a mere reflection of the real economy – though exactly what is being reflected, how accurately, and to what effect is subject to much debate.

Heterodox economists think the reflection is inaccurate, that the mismatch distorts the real economy, and that the result is booms and prosperity alternating with instability and hardship.

By contrast, neoclassicists view the reflection as accurate. In their opinion, the nominal sphere doesn't distort the real economy, it facilitates it. Money and its financial derivatives mediate the economy. Operating as a lubricant, they eliminate the friction of commodity-for-commodity barter while bridging the past with the future. But a lubricant doesn't make things, it merely makes them move more easily. In and of itself, the nominal lubricant produces nothing and generates no utility. It is simply a veil we can see through and safely ignore.

And that is exactly what neoclassicists do. Their basic models, both micro and macro, are articulated in real terms, usually without any reference to money, nominal prices, debt and credit. These latter entities enter the picture mostly as final decorations, addons whose main purpose is to account for inflation, deflation, currency fluctuations and other nuisances brought about – or so we are told – by the distorting interventions of governments.

According to this perspective, points out Keen, private credit and debt are inconsequential. A money loan of one person is a money debt of another. They cancel out. And since banks simply translate the saving deposits of some into loans made to others, they too are inconsequential.

Of course, banks are not useless. They help eliminate the friction of barter and facilitate the creation of deposits-read-money through the money-multiplying cycle. But according to the neoclassicists, says Keen, they do so merely as *instruments* of the state. It is the state that issues high-powered money; it is the state that injects this high-powered money into the banking sector; and it is the state that uses its reserve ratio and interest rates to regulate the subsequent money-multiplying cycles in which bank loans turn into bank deposits. The private sector – both banks and borrowers – can only limit this process by lending and/or borrowing less than the maximum, but it has no control over that maximum. Only the state does.

The neoclassical view of public finance is very different. Unlike private debt, which neoclassicists claim is offset by private credit and therefore has no macro consequences, public debt eats into private activity. When the state spends – usually inefficiently and unproductively according to the neoclassicists – it 'crowds out' efficient private investment. Moreover, to finance its spending without stocking inflation, the state must borrow from the private sector, and as this borrowing and its associated debt services accumulate, they choke the country's finances, causing more crowding out and lowering economic growth even further. In the neoclassical universe, government is bad business.

But this view, Keen argues, puts the world on its head. To start with, as heterodox economists have long claimed and MMT (Modern Monetary Theory) recently formalized, deficit spending does not require the state to borrow anything: its very spending *creates* new-deposits-read-new-money. In this context, the only reason for government to tax is to eliminate this newly created money. Moreover, when the economy has unused capacity – and modern capitalism almost always does – state spending crowds out nothing. Putting unused capacity to work boosts economic activity, not undermines it. Finally, unlike private debts, the public debt, provided it is issued domestically, cannot drive a government that creates its own money 'out of business'. In this sense, it is rarely if ever destabilizing.

The situation with private credit and debt is exactly the opposite. First, contrary to the neoclassical stand, says Keen, banks are not passive intermediaries under the thumb of their government regulators. Far from it. According to recent Bank of England and Bundesbank publications, private banks extend loans – and in so doing create new money – *independently* of their existing deposits and usually with full accommodation from their central-bank regulators. In other words, the new money they create does *not* cancel out, which means that neither the banks nor the money they create can be ignored by macroeconomic theory. Moreover, the size of this newly created privately money can be as big as one third or more of aggregate demand, so it has enormous impact on the level of economic activity. Finally, and crucially, this 'bank-originated money and debt', or BOMD, as Keen calls it, is highly volatile. According to Keen, these three considerations imply – and long-term time series confirm – that bank-originated money and debt are a key driver of the economy and a major contributor to its booms and crisis. And this situation, he adds, must be changed.

In his opinion, high private debt, which neoclassicists are indifferent to and even encourage, is in fact the biggest threat to capitalist stability. And this threat, he and others argue, can and should be defused in two main ways. One is a 'modern debt jubilee' that will replace private bank debt with new fiat money and corporate debt with newly issued equity. This scheme will keep the overall amount of money in the economy unchanged, but in substituting fiat currency for private debt it will curtail the risk of triggering what Irving Fisher famously called 'debt deflation'. The other way to reduce the risk posed by private debt is to redirect private lending from speculative to productive activity and limit unproductive debt-boosting trading on the secondary equity market.

This analysis is exactly opposite to the one offered by neoclassical macroeconomics, and if credit money and debt – along with the private banks that create and regulate them – matter as much as Keen insists, it means that neoclassical macroeconomics must be rejected. And that's just for starters.

2. Economics sans Complexity

Keen's second point is that, regardless of their theory, neoclassicists are locked into an outdated mode of analysis. The economy, just like our brain and the ecosystem, he points out, is a 'complex system'. Its components interact in *nonlinear* ways, and the outcomes of these nonlinear interactions are *inherently* unstable. Neoclassical analysis, though, is oblivious to these patterns.

In general, its models are linear rather than nonlinear, and the way in which they are conceived and constructed leads to stability rather than instability.

To non-economists, this latter type of modelling may seem puzzling. If the neoclassical emphasis on linearity and equilibrium is right, where do business cycles and major crises such as the Great Depression of the 1930s and the Global Financial Crisis of the late 2000s come from? The neoclassical answer is simple: they are 'exogenous'. They come from *outside* the model. In their scheme, the business cycle is the fault of technological shocks; stagflation is the fault of greedy labour unions, Middle East oil sheiks and the weather gods; and great depressions are due to monetary policy errors and other sundry distortions. According to the neoclassicists, these factors are all important; but since they are external to the economy proper, they are someone else's problem, not theirs.

And that's even stranger. If important factors affecting economic change come from outside the model, why not internalize them? Just think how flaky it would look if physicists kept the bending of space/time, entanglement, dark matter and black holes exogenous to physics proper.

But neoclassical economists aren't physicists. Yes, they claim to be scientists. In fact, in their view, their economics is the 'hardest' social science of all.[2] Unlike physicists, though, neoclassicists have another role, which is to protect and defend the capitalist system, and to do so at all costs. And when these two roles conflict, it is always science that yields.

The question of whether to use complex or linear models is a case in point. Neoclassical dogma emphasizes the 'invisible hand'. A free market economy, it stipulates, doesn't need instructions from God or his earthly representatives. It governs itself, automatically and optimally. Left to its own devices, it leads to prosperity, stability and justice, and this supposed outcome serves a purpose. It makes capitalism look like the best of all possible worlds and offers an effective slogan against alternative forms of social organization. Clearly, it cannot be given up. And since complex-systems analysis shows this outcome to be practically impossible, it will be suicidal for neoclassicists to ever endorse let alone adopt it. Science be damned.

Of course, throwing away science has consequences. During the 1970s and 1980s, post-Keynesian economist Hyman Minsky proposed his 'financial instability hypothesis', arguing that a relatively stable capitalism encourages borrowing that is initially hedged (with enough earnings to cover both repayment and interest), subsequently speculative (with earnings covering only interest payments), and finally Ponzi-like (where earnings cover neither repayment nor interest).

The surface tranquillity of this process, Keen points out, misled neoclassicists to celebrate the apparent dampening of the business cycle (the 'great moderation') while blinding them to the incessant build-up of hedged-turned-speculative-turned-Ponzi private debt. No wonder they were dumbstruck when the Global Financial Crisis of 2007-10 finally popped the bubble.

Keen himself wasn't fooled by this great moderation. In the mid-1990s, he predicted the coming financial crisis, and his prediction was not a mere hunch (Keen 1995). Impressed by

[2] Here is a telling anecdote. In the late 2000s, just after the Great Financial Crisis, Nitzan requested to have his political science undergraduate seminar, 'Political Economy of Capital Accumulation', cross-listed with the economics department at York University. The economists rejected the request with a one-liner: 'we do things rigorously'.

complex-systems analysis, he developed a nonlinear Minsky-like model (and subsequently named his software package after him!). Using very simple macroeconomic aggregates, the model shows how increasing economic stability encourages the build-up of private debt till the system eventually crumbles under the weight of debt deflation. Instability, his model demonstrates, is *inherent* in the complex-systems nature of capitalism.

The success of such models puts neoclassicists in a bind. On the one hand, having celebrated the end of deep crises while a major calamity was brewing right under their nose made them look incompetent, if not plain silly. On the other hand, they remain politically forbidden from adopting nonlinear models such as Keen's, lest these models show that crises come not from outside capitalism, but from within.

Their usual justification for rejecting nonlinear modelling is that they lack 'micro-foundations' – or, in simple words, that they don't rely on autonomous, maximizing agents. But this justification is mis-founded, and for the most embarrassing of reasons.

First, as Keen points out, macroeconomic models cannot be derived from neoclassical micro-economic foundations, because these micro-foundations lead to macro-contradictions. In and of themselves, the individual atoms of the neoclassical world – namely, its autonomous utility-maximizing consumers and profit-maximizing producers – tell us exactly nothing about market demand and supply curves. As neoclassical economists (should) know full well, movements on downward-sloping individual demand curves change the distribution of income and therefore shift those very curves; if the individual downward-sloping demand curves shift, the *ceteris paribus* assumption (all else remaining the same) no longer holds; and without *ceteris paribus* these curves cannot be aggregated, let alone aggregated into downward sloping market demand curves.[3] Similarly with the supply side. In neoclassical theory, individual supply curves comprise the portion of the firm's marginal cost curve above its average cost curve. But as neoclassical economists (should) know full well, empirical cost curves of individual firms do not rise with output, but rather move sideways or down. In other words, they lie either on or below average cost, leaving nothing to be aggregated into a market supply curve! In short, the so-called micro-foundations of macroeconomic models are a null set.

Second, the very idea that one can deduce the overall rules of any system from its so-called micro particles is dubious to put it politely. If this were the case, says Keen, we would need nothing other than the elementary particles of physics to explain the whole of chemistry, biology, physiology, society, the ecosystem and everything in between. Even if neoclassical economics had legitimate micro-foundations (which it doesn't), they would not be enough to explain the system's macro behaviour.

[3] Neoclassicists bypass the problem by making all consumers identical and assuming their preferences don't vary with income, so that the redistribution of income no longer matters. Apparently, replacing autonomous liberalism with a mind-numbing caricature stricter than Aldus Huxley's *Brave New World* is a tiny price to pay for theoretical consistency. Way to go.

3. Economics sans Nature

The last key point in Keen's journey is that neoclassical economics abstracts from nature (there are no energy inputs or waste in the standard neoclassical production function), and that this abstraction is not only theoretically misleading but deeply dangerous for capitalism, the human race and planetary life more generally.

If the economy continues to grow as fast as it did over the past century, at roughly 2.3 per cent annually, in about 1400 years humanity will need the entire energy emitted by sun, and in roughly 2500 years it will require the energy generated by the entire Milky Ways – that is, assuming we don't toast ourselves out of existence much earlier (Murphy 2021: Table 1.3, p. 9).

And toast ourselves we will. In slightly more than 400 years, even without counting global warming, the waste energy of human industry will raise the average temperature to 100 degrees Celsius, which is when water boils – though, by then, the plant would have been made uninhabitable already (ibid, Table 1.4, p. 12).

The neoclassicists, though, don't see it this way. For those of them dealing with this subject, climate change is really a non-issue. Even if it occurs, they argue, its impact on the economy will be negligible. According to one consensus estimate cited by Keen, a global rise of 3 degree Celsius by 2090 will reduce annual GDP growth by a minute 0.015 per cent. In other words, humanity is safe doing nothing about it.

The problem with these easy-going predictions and do-nothing policy recommendations, says Keen, is that they are baseless. Not only are they senseless, but they contradict the consensus view of real scientists that climate change will make large parts of the world uninhabitable, while undermining vegetation and other forms of life.

So where does this deep divide between the 'two cultures' come from? For Keen, the original culprit is Milton Friedman, who convinced his fellow neoclassicists that, in science, assumptions don't matter. You can assume anything you like. The only thing that matters is your predictions. And that's exactly how neoclassicists model their world.

They begin by observing that planetary temperatures have a range. To illustrate, the difference between cold Canada and hot Burkina Faso is nearly 34 degrees Celsius. And since this large cross-section difference is tolerable, so must be a temporal increase in average global temperature, particularly if that increase is only a few degrees Celsius.

The problem, says Keen, is that cross-section differences in temperatures are nothing like temporal changes in the climate of the entire plant. And there is more. Since assumptions don't matter, the neoclassicists go on to ignore the rise of 'wet-bulb temperatures' that scientists warn will make large sections of the world lethal. They also disregard changes to atmospheric and ocean currents that could radically alter climate patterns around the world. And, most importantly, they snub the numerous climate tipping points that scientists warn about, as well as the possibly of a 'tipping cascade' that might amplify climate change many times over.

And that isn't the end of it. In their works, neoclassicists disregard the socio-political turmoil that will begin way before the full impact of these natural processes is felt. And they are totally silent about financial markets, whose forward-looking anticipation of these changes could rock the world before any of their material and social consequences come to bear.

For the neoclassicists, assuming these conditions away is sensible. After all, their main role is not to search for the truth, but to defend capitalism. And since most scientists are convinced that capitalism warms the plant, the neoclassical reply is that this warming is inconsequential.

And that is where Keen sees a bitter-sweet ray of hope. In his view, the rosy neoclassical climate predictions will prove dead wrong; the gravity of this failure will help expose the fraudulent underpinnings of the neoclassical dogma; and this exposure will open the door to a 'new economics' where assumptions matter, and where money, complexity and nature are taken seriously. Hopefully, we'll survive to see it happen.

4. Beyond Economics

This is a brilliant book. It deals with a crucial subject and it does so with precision, wit and accessible prose (though some parts are more demanding than others). We recommend it highly to anyone who wants to understand the key challenges of our time. Even neoclassicists might find it educational!

But the book also has one important limitation: it is about economics.

Keen offers to replace neoclassical dogma with a new way of thinking, researching and engaging with the economy. And while we agree that neoclassicism is a religion dressed as a science, in our view, what should come in its stead is not a different type of economics, but a new theory of capitalism more broadly.

This isn't semantic nit-picking. All economic theories – including neoclassicism – engage with non-economic entities and forces. They all agree, willingly or reluctantly, that politics, sociology, anthropology, psychology, international relations and other aspects of society affect the economy. But these effects, whether supportive or distortive, are assumed external to the economy proper. And this assumption is pivotal. Although the effects of these so-called external factors alter economic outcomes, they leave the economic *categories* themselves intact. And this bifurcation, we argue, is the Achilles' heel of all economic theories, orthodox and heterodox, old and new.

In our view, capitalism is not an economic system, but a conflictual *mode of power*. Those who rule this mode of power – its dominant capitalists, politicians, mainstream academics, opinion makers and the various organizations they control – make every effort to conceal its power features. This is why neoclassical economics, beholden to its masters, can never be a science. But the problem besieges every and any economic theory that keeps power external to its basic categories. In our opinion, it is only when the study of capitalism substitutes for the narrow understanding of its economy that power can assume centre stage to reveal what economics is structured to conceal.

Hopefully, Keen's next project can expand in that direction!

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