

Davidson, Paul

Article

"We have to change the rules". Interview with Professor Paul Davidson

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Forum

»We have to change the rules«

*Interview with Professor Paul Davidson**



You are looking back on a long life as one of the most influential and renowned Post Keynesians. What was your motivation to become an economist?

Actually, I started out as a biochemist. I taught biochemistry at the University of Pennsylvania where I was going for my PhD. Then I was drafted into the U.S. army during the Korean war. I did biochemical research in the army and that convinced me I did not want to do biochemistry. What do you do if all your training has been in a field in which you do not want to work? You go into business. As I had never taken an economics course, however, when I got out of the army I went for a MBA degree. This was when econometrics was getting started. I had learned my statistical analysis in biometrics, and when I saw what people were doing in what was called econometrics I thought that was dreadful, I could do much better statistical work with one hand tied behind my back. Moreover, I had enjoyed teaching at the university level. So I said to myself, why not become an economist or an econometrician? Therefore, you can have this teaching and you can certainly use some of your background. But at that time it could take you two or three days to run a regression if you had three or four variables in your head and a couple of hundred observations, so I thought this was kind of a silly nonsense. Luckily, I had to take a course in economic theory with Professor Sidney Weintraub. He had just written his book called *An Approach to the Theory of Income Distribution* in which he had attempted to explain Keynes' *General Theory* different from the tradition of Samuelson or the IS/LM model. All the students had to read his book plus every chapter of Keynes' *General Theory*. That was a real treat to me and that is how I became a Keynesian.

You mentioned the General Theory. Would you say that this is your favourite book of Keynes or would you say that it is the Treatise on Money?

I think there is no question that the two books that influenced me most were the *Treatise on Money*, the two volumes of the *Treatise*, and the *General Theory*. They should both be read together, because there is an awful lot of good theory in the *Treatise on Money* of which Keynes sort of assumes that you know it when you go into the *General Theory*. Let me add

* Paul Davidson is Professor Emeritus at the University of Tennessee, Knoxville Tennessee. He is the editor of the »Journal of Post Keynesian Economics« and visiting scholar, New School for Social Research, New York.

that Keynes was a monetary theorist. The word »money« appears in almost every important economics book he ever wrote. It is one third of the title of the *General Theory*. The only one where it does not appear is *Economic Consequences of the Peace*. If you believe what Keynes said about an entrepreneurial economy it is an economy where money is never neutral.

In his three volume biography of Keynes, Skidelsky says, what I have argued for three decades, that for Keynes the problem of the economy was the need for contractual certainty: money and contracts are the essence of a monetary economy. Within the framework of the classical system you are allowed to re-contract without penalty if you make a mistake and agree on a trade at a non-equilibrium price. However, the only thing in the real world that is true is that you are not allowed to re-contract without penalty. You can enter into another contract, but you get penalised for making a mistake. So contracts and money are the essence of the way we organise production and exchange. Think about the South Sea Islands or the tribes in the Amazon: they are fully employed, they do not have money, they do not have contracts. But they also do not have much prosperity. In a money-contract system money is the essence of the problem and the essence of the solution.

In 1981 you published an essay titled Post Keynesian Economics: Solving the Crisis in Economic Theory. Do you think that economic theory is still in a crisis and that Post Keynesianism is the remedy?

I think it is probably in a worse crisis than it was in 1981. When Post Keynesians split off in the 1970s and the early 1980s, they were taken seriously. People like Bob Solow and Jim Tobin actually downplayed Post Keynesians but they felt the necessity to explain why they did not like Post Keynesianism. Beginning in the late 1980s and early 1990s, these older people who had a problem with Post Keynesian economics started getting old and dying off and younger people – who were called New Keynesians – took over the old neoclassical Keynesianism. They did not know what Keynes's book is about. They never read the *General Theory*. And so they continued to ignore Post Keynesian economics.

I remember one time Jim Tobin and I were at a conference together. We were both attacking the New Keynesians and why they were wrong and Jim said to me: look, you and I both agree that it is not these rigid wages and prices that are the problem. Why cannot we stop criticising each other and present a united front against these New Keynesians? I said, fine, we can build a united front against them, but you and I still do not agree on what the basic theory is. We may agree that they are wrong, but there will be problems coming up. Your theory is going to tell you the solution is »a« and my theory is going to tell me the solution is »b«. Therefore, we will still have critical comments about each other. Until we can agree on the basic theory we really cannot form a united front. We swore to leave it at that point.

There is still no united front of the Post Keynesians?

I do not think there is any front. The Arrow-Debreu basic foundation has taken over not only the – what we would call – New Classical and/or the old Monetarist school; but even the mainstream Keynesians argue from the same Arrow-Debreu theory. So there is not any evidence that any mainstream economists take Keynes or Post Keynesians seriously at all.

I have written an article that may be published called *Paul Samuelson and the Keynesian Revolution. The evidence of who killed Cock Robin*. It refers to the English folk tale of Robin Hood. Who was this Robin Hood who redistributed income from the rich to the poor? And who killed him? They never found out who killed Cock Robin. And Cock Robin in my case is the Keynesian revolution. All the things that particularly Samuelson, but not only him, did, killed the Keynesian revolution – or I should say: aborted it, because the Keynesian revolution never grew up. Maybe that article will encourage some people to go back and see what Cock Robin had to say.

What are the most important developments in Post Keynesian or Keynesian thinking right now?

In the 1980s it was policy orientation, and that would have been incomes policy. I think now the big problems involve international finance. We need a new Bretton Woods conference where the major powers get together and re-design the international financial system. We have a global economy now, and as soon as we prevent the United States from running huge trade deficits we are going to push the whole world into a recession because after all the U.S. trade deficit is mainly responsible for your export industries' profitability.

Can you elaborate a bit on your proposal on the international financial architecture, the International Monetary Clearing Unit?

Most people face the issue in terms of fixed versus flexible exchange rates. But that is not really the problem. There is a desire that exchange rate movements be orderly. It is like the stock market or the Dow Jones average: where there is a flexible market, but nobody wants to see the Dow Jones go down or up 500 points in a day. If the Dow Jones-average moves ten points one way each day and ten points the other way nobody cares. So it is not fixed *per se*, what is needed is exchange rate stability.

In my proposal there is an institution that maintains stability, but under certain specific conditions exchange rates can be adjusted. The proposal is really a 21st century spin-off of what Keynes called the Bancor system, where he suggested to introduce an international currency called the Bancor and a supranational central bank. Everybody would use their own domestic currency, but international transactions would be effected in terms of the Bancor. The central bank would make all the necessary adjustments.

I use the following example in my classes that might be useful. The U.S. has a federal reserve system as the central bank. Unlike most central banks, the U.S. actually has twelve different central banks – one for each of the federal reserve districts. Now what happened before the introduction of the federal reserve system in the event of regional current account imbalances – which can occur because they are regional differences in trade all the time. Let us assume a region where they were importing much more than they were exporting. What happened is that the banks in that region lost reserves to the banks in other regions, and ultimately the industries in the deficit region got poor and poorer. The ultimate result was that in the deficit region we had what, in the old westerns, are called ghost towns – towns where industry and people abandon because there is no economic future there. It is, however, not a very good solution when everybody would move to other regions.

Starting with the federal reserve system in 1913 they had to solve that ghost town problem. One of the ways they solved it is that each federal reserve district bank sets its own rediscount rate. You can attract funds by having rate differentials between federal reserve districts and you trade funds back and forth, which is of course what, globally, we do now between national central banks. But you often have to have sky-high interest rates to significantly reduce current account deficits.

The other thing that happened which makes a big difference in regional current accounts in the U.S. was the New Deal of the 1930s under President Roosevelt. The federal government taxes people in all the twelve regions and then decides where to spend. If there is a progressive income tax the region with growing current account surpluses has to pay more taxes. Then under Roosevelt's New Deal government more money was spent in the depressed areas, so that the bank reserves were re-cycled from surplus regions to deficit (depressed) regions. Continued trade is permitted, and there will be no ghost towns. So this is the way we reduced the effect of regional trade imbalances within the United States. But of course: a) you do not have a world central bank, and b) you do not want to have a central world government taxing and spending in different regions. So some sort of system is needed that emulates this without having the world central institutions. This is what Keynes tried to work out at Bretton Woods.

For the last fifteen years the United States experienced very dynamic markets and high growth rates, but there are also the budget deficit and the current account deficit. Are these deficits the price the U.S. has to pay for its growth?

One of the things I would like to emphasise is that deficits are not a price. If you think about it in terms of current accounts the United States is getting a free lunch. Every month people from outside the U.S. are giving people inside the United States more goods and services than we in the U.S. have to work to earn these goods and services. So, deficit *per se* is not a price, it is not a real cost. But it does create jobs in export surplus nations.

Why, for example, are the Chinese so anxious to continue running huge export surpluses? You may remember that in the good old days of the old Keynesian argument versus the Monetarists in the 1970s we used to argue that there were four components of aggregate demand: consumption, investment, the government, and the foreign sector. The Keynesian answer to a recession or unemployment was to raise the aggregate demand curve. You could do it by cutting taxes to stimulate consumption, by lowering interest rates to stimulate investment, or government could run deficits by cutting taxes or increasing expenditures. But the fourth method of raising the aggregate demand function is, of course, increasing exports relative to imports.

What happened when the neoclassical economists took over mainstream economics? The economist profession convinced the government that deficits are bad. So the government could not use fiscal policy to raise the aggregate demand curve. It also cut out the idea of introducing a Robin Hood tax – tax the rich who have a lower marginal propensity to consume and give it to the poor – and stimulating consumption that way. There was also the idea that central banks' most important aim is targeting inflation and not keep-

ing cheap money in order to stimulate investment. So there goes the investment. The only acceptable way to stimulate aggregate demand in the late 1970s and early 1980s became export-led growth. And it worked. Germany was one of the prime examples. It not only worked because it created jobs. When there is some degree of exchange rate flexibility a current account surplus tends to raise the exchange rate so that the standard of living goes up because imports become cheaper. This was a way of preventing inflation because in the 1970s and early 1980s German trade unions did not have to demand higher wages to get higher real wages as the exchange rate did the job. Export-led growth became – if you want – a strange form of aggregate demand stimulus. However, the fallacy is that not every country can run an export-led growth policy.

Maybe there is a further problem. In Germany we have export-led growth, Germany is very competitive and very successful in exports. Nevertheless, unemployment is surging. Which policy recommendations do you have for the new grand coalition in Germany?

The problem is that there are certain rules of the game, which are wrong. If a country asks me – and I have gone to several Latin-American countries who have asked me what policies I would recommend to stimulate their economic growth and prosperity – my answer is that any nation by itself has to play by the existing rules of the game because the nation cannot play otherwise. Currently, the rules of the game are to become more competitive and to promote export-led growth, which is bad for the whole system. But if a nation can keep ahead of the game export-led growth can be good for the nation even though it is bad for the system. So my answer is that we have to change the rules.

Why do we not change the rules of the game and introduce a new Bretton Woods system? If a nation does not want to become completely isolated and to run the domestic economy as an autarkic closed economy, then the solution requires the system to run the way the United States ran the twelve districts of the federal reserve system where potential negative effects of regional deficits are corrected. I would recommend Germany to have the United States, the G7 and the Far East come together and introduce a new Bretton Woods.

Of course this is not easy. Let me give you an illustration. In 1997/98, after the Asian crisis and the Russian debt default, President Clinton called for a new financial architecture, as global financial markets were in a very serious, almost chaotic state. I had already written this proposal on the International Monetary Clearing Unit. So one day I get a phone call from the United Nations. The G24 group of nations is afraid that the entire financial system is going to collapse. They want to have a meeting in January 1999 to draft a proposal mainly to the G7 for a change in the international financial architecture. So the G24 group invites me to come to Geneva and present my proposal. I go there, and the group that we meet are the finance ministers and the head central bankers of these 24 countries, Joe Stiglitz who was there for the World Bank at that time, some people of the International Monetary Funds, and five other academics. We finally get to an agreement to adopt basically a proposal similar to the one that I suggested. They set up a committee that was going to write up the proposal and then prepare it for presentation to the G7.

After hearing nothing from this committee again for several months, I call up the chairman to ask whatever happened. He says that after writing up this proposal everything settled down, the capital markets started to work again. Consequently, there is no need for the proposal, and it goes down the drain. Apparently, the only way you can get people to introduce this proposal is to have a cataclysmic crash. I am often told that the adoption of my proposal will work only when the foreign exchange markets collapse completely and when we enter into another Great Depression. But I do not want victory at that price. So what to tell Germany to do? The answer is: do not wait for the crash, do some preventative medicine.

In the United States there are some Keynesians who are very influential, like Joseph Stiglitz or Gregory Mankiw and Ben Bernanke. But it seems to me that most Post Keynesians are more or less at the margin and not at the heart of government decisions in the United States. Is that correct?

Interesting, the people that you mentioned ... I had some discussions with Mankiw. In fact I invited him to give some lectures down at Tennessee. He does not even know what the *General Theory* book looks like – even from the outside. He says, why bother reading it. If it is important it is all in Samuelson. He calls himself a Keynesian, but I have no idea why.

Take Bernanke, his argument is that central banks have to be more open and convince people about what they are doing, which helps to stabilise the system. But he wants to stabilise the system not on the basis of the prices of the financial assets, but on the basis of product prices. He wants a target rate of inflation, which seems to me is the wrong way. Central banks can easily stabilise financial asset prices. The only way they can stabilise product prices in case of inflation, however, is by creating unemployment. Which is of course what Paul Volcker did in the 1980s and what the European Central Bank did as well. The element of truth in Bernanke's argument is that the central bank has to do things that people understand, but his target is the wrong target.

Joe Stiglitz is a more interesting type. Since he has left the World Bank and the Clinton administration he has also been calling for a change in the international financial system. His solution is a G7 agreement to create what he calls »global greenbacks«. Any time countries get into a deficit, particularly the less-developed ones, they get global greenbacks – as a grant, not as a loan –, which they can use to continue buying products from abroad and paying off their deficits. However, the problem is that these countries are made »grant addicts«. They will rely on additional grants and never work their way out of their problems. Sooner or later the giving countries are going to refuse further payments: based on the usual Ms. Merkel and Ms. Thatcher »you got to pull yourself up by your own bootstraps«-type of argument. At least Stiglitz sees that there is a liquidity problem at the core, for which the only available solution now is to run export surpluses; because if you get enough liquidity you do not have to worry. The United States does not have to worry because as long as the global economy is on the Dollar standard, the United States is, in essence, the central bank of the world. And what is true even in conventional economic theory: each year to promote economic expansion the central bank is supposed to increase its IOUs to the rest of the economy, i.e., the central bank must increase the money supply, which is based on central bank IOUs. So for the global economy, the United States

are encouraging global economic expansion by creating current account deficits, increasing the number of dollars in foreign reserves, and thereby flooding the world with liquidity. In some sense we are doing the right central bank thing. The problem is of course that people are afraid that U.S. current account deficits cannot continue indefinitely. What will happen when foreigners stop hoarding Dollar reserves?

Because in essence Stiglitz advocates these crazy global greenbacks to take the place of U.S. current account deficits to provide foreign reserves for other deficit nations nobody takes him seriously anymore. When Stiglitz was for cutting deficits and the usual traditional transparency to improve knowledge in free markets he was taken seriously, he even won the Nobel Prize. I would separate him out from Bernanke and Mankiw.

Uncertainty is another important issue in your work. If you say the future is uncertain – can we still say anything certain about the future? Can we still do economics?

Let me start by elaborating a little on uncertainty. 19th century economics was perfect certainty; the future was known. In the beginning of the 20th century they got to the idea that the probability distributions may be unknown, and there were subjective probabilities and objective probabilities, future outcomes depending on the latter. The only question was, What if people make mistakes and do not estimate the objective probabilities? If you assume a Bayesian perspective on this issue you start off by assuming decision makers do not know anything about the economic environment – and therefore assume a 50:50 probability for any future occurrence. Interestingly, this is also stated by Keynes in the *General Theory*, although he does not call it Bayesian. However, this 50:50 probability results in absurd conclusions. The Bayesians would say as you collect evidence you change the Bayesian priors, and you get closer and closer to the objective probabilities.

So the fundamental question is as follows: is the uncertainty due to the fact that objective probabilities do exist, but humans do not have the capability of analysing the existing data and immediately making their subjective probabilities equal to the objective probabilities? Instead humans use subjective probabilities that, in the short run, may differ from the objective probabilities but in the long run approach the objective probabilities. That would be called epistemological uncertainty.

Or is it rather the case that there are no existing objective probabilities that govern the future outcomes – that is ontological uncertainty based on the assumption that important economic outcomes are the result of a non-ergodic stochastic process. I am on the side of the non-ergodic ontological argument regarding uncertainty.

What I am saying is that there is not enough information existing today for obtaining probabilities about many important future outcomes. Nevertheless, this does not mean there is nothing government can do to assure future prosperity, employment, and economic growth: we do know that we can always improve the system by making sure that there is never a shortage of liquidity and a lack of effective demand. If there is a liquidity and/or an effective demand problem, then the government – and nobody else – can correctly control liquidity supplies and the level of effective demand and thereby fix the problem easily and rapidly. So the answer is that even in a world of uncertainty there is something that the

government can do to relieve its residents of the pressures of depression, unemployment, and inflation. If government cannot do it, nobody can do it. There is no alternative.

But with independent central banks not only the government has to do something, but also the central bank.

But the central bank of every country is the creation of the parliament. So the central bank is never independent unless the parliament makes it independent. Therefore, we – the people who control the parliaments in a democracy – can control the central banks anytime. Again, what is required is some sort of Bretton Woods of the world-type kind. The governments of the world have to get together and agree on a new financial architecture, which has to protect everybody from unemployment. What are the institutions that we need accordingly? Keynes suggested the Bancor, arguing that there will still be deficits and credits in the current account. Therefore, according to Keynes' concept of the Bancor there has to be a rule that requires surplus countries to spend their surpluses to prevent them from continually running surpluses. Japan was running huge surpluses when, in the 1980s, I started pressing this argument for nations with large and persistent current account surpluses to accept the responsibility of spending down these surpluses. Spending surpluses will create more goods and services for the nation's residents. Otherwise surplus economies are going to suffer because sooner or later people in the current account deficit nations are not going to be able to buy the surplus nation's exports and therefore reduce the profitability of the surplus nation's export industries. So Japan did not take my suggestions seriously, and instead the Bank of Japan tried to deflate the stock market and real estate bubble of the 1980's. The result was ultimately, Japan went through ten years of depression and had to run up huge government deficits – without really having been able to solve its problems. We need agreements among governments, and this is the problem: because politicians are not economists, they have been taught that free markets will do it. We have to convince them that free markets will not do it. Free markets cannot automatically solve our serious economic problems while maintaining full employment and rapid economic growth.

In this process of convincing people, what is the role of heterodox journals like the Journal of Post Keynesian Economics? Do they make a difference?

The question is if anybody reads them besides Post Keynesians, and if we get anybody else to listen: this is the hard part, and it becomes more and more difficult. As I said, in the 1970s and early 1980s tax-based income policy was on the political table. People were interested in what Post Keynesians had to say. As things go along they become less interested.

I wrote an article titled *Is Probability Theory Relevant For Choice Under Uncertainty? A Post Keynesian Perspective*, which was published in the Journal of Economic Perspectives in 1991. Joe Stiglitz was the journal's editor at that time. Stiglitz required me to write 21 drafts of this piece because he did not like what I was saying about New Keynesians, and the result was that the published version of my article lost some of the most telling points. It did not make the impact that it was supposed to make. However, here is an interesting point that I did not realise until somebody brought it to my attention. Nobel Prize winner

Doug North has cited my JEP article in a paper of his explaining why economic growth does not take the path that the classical economists predict. North has accepted this whole idea that the future is non-ergodic. So there was somebody who did read my article and got the idea. Unfortunately, he is only one – but he is a Noble Prize winner. If people take Doug North seriously more people will start worry about non-ergodicity. Perhaps we Post Keynesians will get back into the mainstream or close to it anyhow.

As the editor of a well-established journal beyond the mainstream, what advice would you have for a new journal like ours? Or in other words, what is the essence of a good journal?

When Sidney Weintraub and I started the Journal of Post Keynesian Economics Kenneth Galbraith came to us and said, I think it is a great idea. But you cannot wait for manuscripts to be mailed in or to be solicited. You have to continually organise symposiums on important policy issues, and you have to invite people of all distinctions to come in and discuss this policy issue. That is what we have done. I have had, for example, John Williamson who certainly is not a Post Keynesian; but he has been very gracious and he has been willing to come in to our discussions on the Washington Consensus and to put his arguments up against ours. That is useful. We have had Allan Meltzer. We have had some conservative people who are willing to do that. One time we had a big symposium, which was based on some articles of Milton Friedman. I invited Friedman to participate. I gave Friedman a copy of all the other papers in the symposium, but Friedman did not want to write a reply. Friedman's response to my invitation was something like, »I treat my articles like my children; once I give birth they are on their own«. The point was that Friedman did not want to get into a discussion, and this is the hard problem because – again – if you only have a discussion between people who all are »Post Keynesians« it does not have an impact. You have to pick a political topic and get one or two people from the other side who are willing to put themselves out on a limb, and you have to make them feel comfortable about writing in a journal where most readers are not going to agree with them. Then if you are lucky it may be picked up by the media, and that will give you much more exposure.

The interview was conducted by Torsten Niechoj in November 2005.

Selected Publications of Paul Davidson:

The Collected Writings of Paul Davidson, 3 vols., Basingstoke: Macmillan 1990 ff. • Post Keynesian Macroeconomic Theory. A Foundation For Successful Economic Policies For The Twenty-First Century, Cheltenham: Edward Elgar 1994 • Are Grains of Sand In The Wheels of International Finance Sufficient To Do The Job When Boulders Are Often Required?, in: The Economic Journal 1997 • Financial Markets, Money and the Real World, Cheltenham: Edward Elgar 2002 • Is Fixed Exchange Rates the Problem and Flexible Exchange Rates the Cure?, in: Eastern Economic Journal 2003