Paul Davidson, Who's Afraid of John Maynard Keynes? Challenging Economic Governance in an Age of Growing Inequality, 2017, Palgrave-MacMillan, 162 pp. ISBN 978-3-319-64502-2.
Book review by James K. Galbraith

Paul Davidson, in his ninth decade, has produced a crisp and clear exegesis of essential Keynesian ideas and the critical failures of so-called mainstream economic thought. The most critical flaw lies in the treatment of time. Rooted in ancient ideas of equilibrium, harmony and social balance, mainstream economics treats the future as an extrapolation of the past, predictable except for random errors, which are called "risk." This as Davidson insists is incurably incorrect; there is uncertainty and at any time financial markets are prone to collapse in a failed flight to safety, which drains liquidity and deprives both financial and physical assets of their market value.

From this it follows that in the social sphere any model that projects the future from the past will fail from time to time. The models work so long as things do not change! As for change, for turning points, they nevertheless occur. And that those who believe most in the model will prepare the least and be hurt the worst. And yet, for the economy to function, "belief" in the model – at the least, conditional belief sufficient to motivate consumption and investment – appears essential. Without it, the private economy cannot prosper. Living in a house of cards is better than having no house at all.

When the house collapses, the alternative is the state, an overarching entity. As Davidson writes, the state can always fill the gap, and this is his second big point: money is the creature of the state and it cannot run out. But how well can the state do this work? Skepticism on this point separates Keynesians from communists, giving rise to the glorious political paradox, that Keynes and Davidson deploy revolutionary thought not to destroy but to preserve the social order. More precisely, they seek to rescue the capitalist system from itself. In this way, it becomes the function of Keynes's followers to show how an unstable system can be rebuilt, time and again.

The desire to save – to forebear consumption, to practice thrift – is the root of mass unemployment. Austerity policies foster private insecurity and saving, and at the same time they block the public sector from offsetting action, from undertaking the spending that the private sector does not wish to do. This as Davidson describes it is “the incomes policy of fear.” Fear spares the business leaders from the distasteful obligation to cooperate with labor to achieve price stability at full employment. And it spares the government the cost and inconvenience of maintaining buffer stocks to stabilize commodity prices. Business can therefore rule, while the larger population labors under insecurity and far more poverty – or anyway, less prosperity – than might otherwise be achieved.

From this point Davidson turns to the Great Financial Crisis of 2007-–2009, and to the lethal fact that the entire corpus of mainstream economists were unable to foresee it and had in fact persuaded themselves of a Great Moderation which, they imagined, might go on forever. According to a session at the annual meetings of the American Economics Association as the crisis was unfolding, the world had “achieved consensus on monetary policy”; the end of economic history was at hand. That consensus believed that deregulated markets spread risk, specifically that financial derivatives were an effective insurance against major loss. In fact, they served as vectors for panic, turning a crisis of the US mortgage markets into a global financial meltdown. Markets collapsed everywhere. And those who had bought the derivatives were illiquid, and so faced ruin, even if the underlying securities might – as they did in many cases – pay off over time.

What is to be done?

Davidson places faith first of all in the state, which must intervene first to regulate the financial sector and second to stabilize the great flows of consumption and investment on which economic activities depend. But states themselves are embedded in a global system, and not every state has the economic independence enjoyed by the large nations at the core of the world's monetary systems. It therefore follows that the world needs a system of international monetary stabilization and control – a Keynes Plan – that will prevent the most successful trading nations, who run chronic surpluses, from imposing austerity on their deficit-running and indebted trading partners. For this to work, Davidson proposes a new International Monetary Clearing Union and accompanying capital controls to permit national regulation of national financial markets to work.

The Keynes Plan had no chance back in 1945, as the great creditor nation of that era, the United States, had other ideas. Today the great creditor of Europe – Germany – would be no less obdurate, while the US government on these issues is wholly in the hands of Wall Street banks and of hustlers advancing their interests. Still, it is a good thing that Paul Davidson continues to remind us of how far from sanity and civilization we have drifted, in the decades since the death of Keynes.

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