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Keynes' Interventionist-Reformist Economic Policies

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Introduction

The economic policy analyses and proposals that Keynes advanced on monetary, fiscal, exchange rate and income policy while an adviser to the British Treasury, together with the theoretical conceptions and economic prescriptions contained in his essays and books (the most influential of which was *The General Theory of Employment, Interest and Money* –hereafter General Theory), influenced the course of capitalism and revolutionized the study of modern Economics.[1]

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[1] It is no exaggeration to say that, from the years immediately following publication of the General *Theory of Employment, Interest and Money* through to the early 1970s, Keynesian macroeconomic policies –characterized by counter-cyclic fiscal and monetary policies, managed exchange rate policies and income policies– and State intervention in, and regulation of, the economy not only restructured the dynamics of capitalist economies, but were fundamental to steering them towards a more welfare state situation.

By the 1970s, with the breakdown of the Bretton Woods international monetary system and the stagflation crisis in the developed countries, Keynesian theory and policies were considered dead (Lucas, 1980), and, as a result, neoliberal economic policy strategies resting on both the idea of the minimum State and an unshakeable faith in the efficiency of free markets came to the fore in academic circles and among policy makers. In that direction, the 1980s and 1990s embodied the hegemony of neoliberal principles, which found its most emphatic expression in economic globalization, in that this substantially altered the nature and determinants of the world economy; *i.e.*, trade and financial liberalization of economies, deregulation and innovation on financial markets, and liberalizing structural reforms –such as divestment of State assets and social security reform (designed to downsize the public sector), tax and labor reforms– all limited the scope of nation-States' macroeconomic policies.

With the international financial crisis of 2007-2008 –which, incidentally, originated in the United States subprime mortgage market[2] –and fallout from it on the real side of the economy, the debate over increased State intervention in the economy re-entered the order of the day and everyone turned Keynesian.[3]

In the course of his work, Keynes centered his attention and energy on (i) understanding the nature of the economic problems of the modern entrepreneurial economies (monetary economies), such as price level instability, cyclical fluctuations in levels of product and employment, concentration of wealth and financial crises, and (ii) offering solutions to these problems that tend, as a rule, towards State regulation of capitalism and pursuit of a new world economic order.

As will be seen below, in monetary economies, economic agents' decisions to spend, whether on consumption or investment, are made in contexts of expectations conditioned by uncertainty as to future outcomes. Accordingly,

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2 The international financial crisis is analyzed in detail in *Associação Keynesiana Brasileira* (AKB), 2008 and 2010.

3 As can be seen in Mankiw (2008) and Krugman (2009).

in such economies, generation of employment and income depends on entrepreneurs' expectations for future social appropriation of what they have taken the risk of producing. Thus, in situations where expectations about the future become uncertain, economic agents' manifest a preference for liquidity, and effective demand does not materialize, resulting in an increase in involuntary unemployment.

In such contexts, Keynes argued, the unstable dynamics of monetary economies can –and should– be stabilized. To that end, he made it clear that State action through counter-cyclical economic policies, designed to socialize investment, was the path to stabilizing the economic cycle and a society's levels of employment and income. In that respect, Keynes signaled fiscal policy as the automatically stabilizing economic policy *par excellence*.

The intention of this article is to present the *modus operandi* of economic policy in Keynes –especially fiscal policy, which he reveals as the most important. For that purpose, the article is divided into three sections in addition to this brief introduction. The next section presents a succinct analysis of the dynamics of monetary economies; the third section, after exploring the importance of monetary and exchange rate policies in deploying macroeconomic policy, and their relations with fiscal policy, presents the logic of fiscal policy in Keynes as a counter-cyclical instrument; and lastly, the fourth section offers some final remarks.

The dynamics of monetary economies

At the general level, the cyclical instability in levels of product and employment was always one of Keynes underlying concerns (Ferrari Filho, 2006a). Ultimately, declared Keynes, the problem of fluctuations derives from the fact that "a monetary economy [...] is essentially one in which *changing views about the future* are capable of influencing the quantity of employment and not merely its direction" (1964: vii, emphasis added). In other words, in monetary economies, currency is never neutral.

Keynes (1979) regarded the capitalist economies as entrepreneurial economies or monetary production economies. One essential feature of a monetary economy is that currency is not just a medium of exchange, but an asset desired for its ability to serve as a safeguard against agents' changing expectations, because it holds the power to command social wealth over time by affording maximum liquidity to settle economic transactions. However, when entrepreneurs invest, the object of their desire is also to expand the stock of money. For this reason, Keynes (1972: 82) argues that "an entrepreneur is interested, not in the amount of product, but in the amount of *money* which will fall to his share. He will increase his output if by so doing he expects to increase his money profit, even though this profit represents a smaller quantity of product than before".

Keynes sees entrepreneurs as endeavoring to expand their wealth by risking monetary resources in the present in the belief that they will realize their production in the future. That wager, although rational, means that "our decisions […] can only be taken as a result of animal spirits –of a spontaneous urge to act rather than inaction" (Keynes, 1964: 161). Moreover, Keynes argues that investment occurs because, considering the idea of animal spirits, "enterprise only pretends to itself to be mainly actuated by the statements in its own prospectus, however candid and sincere" (Keynes, 1964: 161-162).

However, there is an inexorable dilemma in the economic system: the entrepreneur, the agent who enjoys the capability to apply monetary resources in capital goods, machinery and equipment, and who is thus responsible for employing other individuals and for creating income and social wealth, is constantly faced in his investment decisions with an implacably inscrutable future. In a monetary production economy, it is entrepreneurs' expectations that cause them to give up the currency they hold and wager that the future will bring them more of that currency. As a result, social wealth will be increased and, in some way, distributed only if entrepreneurs' eagerness endorses their decisions to mobilize monetary resources in new enterprises.

In this regard, depending on how entrepreneurs' preference for liquidity (*i.e.*, demand for currency) is conditioned by their expectations for the future, this will induce "movements to substitute forms of wealth, increasing or reducing demand for reproducible assets and thus increasing or diminishing the income generated in the production of new items" (Carvalho, 1994: 47).

Meanwhile, from the classical theoretical perspective, the act of producing is fully justified by Say's Law. The agent decides to produce (supply) because that affords the possibility of consuming an amount of goods and services (demand) equivalent to the disutility caused by the labor effort expended. There are no income leaks, because production is undertaken solely in order to access goods and services, so that all supply generates its own demand.[4] According to Keynes,

> the classical theory supposes that the readiness of the entrepreneur to start up a productive process depends on the amount of value in terms of product which he expects to fall to his share; *i.e.* that only an expectation of more *product* for himself will induce him to offer more employment Keynes (Keynes, 1979: 82).

On this classical approach, economic policy should intervene only to eliminate so-called market failures, notably those where market power lies with a small number of entrepreneurs, who thus manage to manipulate prices and prevent them from accurately signaling social preferences via forces of supply and demand. The market is thus the perfect organizer of economic activity and, in that all economic agents access the market and its perfect body of information, any unemployment is voluntary. As if that were not enough, in line with the fact that the market is proficient in offering all the information necessary for agents' decision making and that, nonetheless, Say's Law is valid, the economic system holds no surprises as it proceeds over time. Accordingly, it can be argued, there is no historical time, because the present will be repeated faithfully in the future. There is, therefore, no uncertainty and no need for agents to hold assets of any kind as safeguards against the economic system's changing course unexpectedly. Accordingly, on the classical view, currency is there only to facilitate exchanges.

[4] For this reason, in *The Means to Prosperity*, Keynes (1972: 350) argues that "many people are trying to solve the problem of unemployment with a theory which is based on the assumption that there is no unemployment".

To Keynes, on the contrary, when entrepreneurs invest they expect there to exist future effective demand for their production. All the same, if entrepreneurs' animal spirits do not encourage them to expend their monetary resources in a production process, *i.e.*, if the preference for the absolute liquidity of currency reigns among entrepreneurs, then their object of desire comes to be their present wealth and not its future expansion. Thus, the direct consequence of cooling entrepreneurial expectations is involuntary unemployment, as well as constraints on the production of income and wealth.

In that context, when Keynes argued that the dynamics of the economic system depends on immaterial factors such as expectations and preference for liquidity, he signaled the need for some institution to inform entrepreneurial expectations, so as to help stabilize levels of product and employment. Keynes regarded the State as that institution *par excellence*, and the prime purpose of its economic policy as being to prevent effective demand in society from customarily falling short of entrepreneurs' expectations, in order that their decisions on how to allocate their monetary resources continue to be directed to purchasing reproducible assets. Thus, as will be described in the next section, Keynes argued that, fundamentally, economic policy should prevent the spread of involuntary unemployment and the occurrence of periods of diminished production of social wealth.

Keynesian economic policies for coordinating the dynamics of monetary economies

In order to buffer oscillations in the changing outlook on the future among those with the power of command over social product (*i.e.*, entrepreneurs), Keynes, in the General Theory, proposed a new social philosophy in order to address the fact that "the outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes" (Keynes, 1964: 372). The focus of his proposal was the power that the State should hold to steer the economic system, given that, if left to the free workings of market, the economic system and economic policies themselves –unless there was coordination among them– would contribute not to solving, but to enlarging the main problems of monetary production economies.

On this particular, Keynesian economic policy is structured so as to make it possible to administer endogenous features in monetary, fiscal and exchange rate policies.

How does it do so? In general terms, it should curb, for instance, any tendency for the basic interest rate in the economy to be operationalized in such a way as to constitute an instrument for absorbing external savings by attracting short-term external capital, which would entail high interest rate levels, thus inhibiting productive investments. Also, in a context with a low basic interest rate, a country's public finances are not be constrained by high public debt rollover cost, thus affording fiscal policy greater autonomy both to administer public spending and to pursue counter-cyclic policies without needing to incur public deficits.

Causal relations among monetary, fiscal and exchange rate policies also show explicitly in the fact that one of the consequences of raising the interest rate is, inexorably, the emergence of twin deficits. In other words, an excessive influx of foreign portfolio capital tends to cause the domestic currency to appreciate, which reflects in a loss of external competitiveness by domestic products and, consequently, a deteriorating balance of trade. As a substantial portion of that capital inflow is directed to purchasing public securities, the federal government public debt increases, as does its financial cost, and fiscal policy, as a result, is called on to correct public sector fiscal imbalances and is thus diverted from its main purpose, which is to originate efforts to stimulate growth in the country's product and wealth, both of which are fundamental for fiscal policy itself to become more manageable in the long run, in that growth in the economy automatically expands the tax base for public revenues.

Now, Keynes was aware that (i) there are causal relations among monetary, fiscal and exchange rate policies, (ii) the cyclic instabilities in monetary economies have unpredictable effects on the state of entrepreneurs' confidence, leading to stagnation in employment and income creation, and

(iii) uncoordinated economic policies, by failing to bolster agents' confidence in effective demand for their products, intensify the potential amplitude of economic system fluctuations. He accordingly prescribed ways of conducting economic policies so that they would assure the good functioning of the economic system.

Such coordination does not entail a planned economy, for that would eliminate entrepreneurial action and transfer it to the agencies in command of central planning; in such circumstances, all that would remain to the entrepreneur would be to carry out the planners' decisions. Accordingly, Keynes' idea of socializing investments should be understood, as can be inferred from Ferrari Filho and Conceição (2005), as the State's participating actively in the economy, through economic policies that signal to entrepreneurs the existence of effective demand for their production; State action should, nonetheless, be in keeping with the set of socially defined and legitimated institutions (such as habitual contractual compliance, confidence in the quality of legal tender, rules that ensure political stability, and so on).

What Keynes proposed as economic coordination is economic policy action closely attuned to whatever "will co-operate with private initiative" (Keynes, 1964: 378). This complementation between State and private initiatives is also underlined by Minsky (1986: 295-296): "once we achieve an institutional structure in which upward explosions from full employment are constrained even as profits are stabilized, then the details of the economy can be left to market processes".

The State is the social entity capable of gathering together the greatest amount of the information available in society and, at the same time, is the social legislator with legal competence to safeguard institutions' ongoing existence and to alter them as required by the historical evolution of the different social systems. It is thus up to the State, for the collective good and not in private interests, to coordinate economic activity.

Keynes' concern with regulatory participation by the State was expressed initially in *The Economic Consequences of the Peace* (1988), published in 1919. Keynes argued that restructuring the world economic and social order depended on regulating capitalism, which would necessarily be conducted by the public agent. In the 1920s, the criticisms of liberal capitalism and the consequent need for State intervention in the economy became increasingly recurrent in Keynes' writings. One of Keynes' essays from that period, *The End of Laissez-Faire* (1972), is particularly arresting.

In the essay, Keynes shows that *laissez-faire* does not reconcile individual and social interests[5] and argues that the main economic, social and political problems result largely from "risk, uncertainty, and ignorance" (1972: 291), asserting that regulation of capitalism is capable of assuring economic stability and social harmony. The passages below point in that direction:

> I believe that the cure for these things [economic and social instabilities] is partly to be sought in the deliberate control of currency by a central institution […] these reflections have been directed towards possible improvements in the technique of modern capitalism by the agency of collective action (Keynes, 1972: 292-293).
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> For my part I think that capitalism, *wisely managed*, can probably be made more efficient […] our problem is to work out a social organization which shall be as efficient as possible without offending our notions of a satisfactory way of life (Keynes, 1972: 294, emphasis added).

Moreover, Keynes (1972: 290-291) argues that "State Socialism […] is, in fact, little better than a dusty survival of a plan to meet the problems of fifty years ago, based on a misunderstanding of what someone said a hundred years ago". Further on in the same passage, Keynes makes it clear that his criticism of socialism was not "because it seeks to engage men's altruistic impulses in the service of society, or because it departs from *laissez-faire*, or because it takes away man's natural liberty to make a million […] all these things I applaud" (Keynes, 1972: 290).

In short, in *The End of Laissez-Faire*, Keynes is aware that the survival of capitalism should depend on the visible hand of the State, so as to regulate the socioeconomic dysfunctions deriving from the market.[6] For that

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[5] According to Keynes (1972: 287-288), "the world is *not* so governed from above that private and social interest always coincide […] It is *not* a correct deduction from the principles of economics that enlightened self-interest always operates in the public interest".

[6] The idea of regulatory action by the State was renewed in the 1980s by Minsky, thus: "Big Government is the most important reason why today's capitalism is better than capitalism which gave us the Great Depression" (Minsky, 1986: 296).

purpose, economic policies should be responsible for State coordination of the economy.

Accordingly, Keynes stresses that execution of monetary and fiscal policies, particularly the latter, is most important for State intervention to exercise proper guidance,[7] along with the prominent role of exchange rate policy. Tellingly, Keynes' discussions of exchange rate policy are connected with his key proposals for restructuring the international monetary system and are directed basically to mitigating economic agents' uncertainty about the pricing of assets negotiated in world trade (Ferrari Filho, 2006b).

Monetary and exchange rate policies

To Keynes, monetary policy should be conducted so as, by administering the basic interest rate in the economy, to promote alignment among the relative prices of assets open to investment in the economic system. Keynes (1964: Chapter 17) held that all assets intrinsically posses an interest rate and that, by comparing the various remunerations on offer, agents could direct their resources –if this were more advantageous in terms of liquidity, carrying cost and quasi-income– to non-manufacturable assets. This would occur mainly when investments made in the past turned into involuntary stocks and, consequently, frustrated expectations.

In view of the foregoing, the basic interest rate set by the Monetary Authority should by fully public knowledge and be held to a level considered normal by that public, true to its conventions, because as pointed out by Carvalho (1999: 275, emphasis added) "people form an expectation of

[7] As shown by Terra *et al* (2009), policies at the microeconomic level can produce distortions, privileges and inefficiencies. Action with more generalized scope, such as macroeconomic policy, can permit private enterprise to operate as comprehensively as possible, while preventing concentrations of opportunity and income. Note also that, in Chapter 24 of the General Theory, Keynes underlines the importance of monetary, fiscal and income policies. For further detail, see: Carvalho (1999 and 2006) and King (2003), which explore monetary, fiscal and income policies, and Thirlwall (1976) and Ferrari Filho (2006b), which highlight the prominence of exchange rate and trade policies in Keynes.

the *normal* interest rate and expect current rates to gravitate around it". Accordingly, as the future is incalculably unknown, agents will always attempt to anticipate the interest rate, which they monitor closely so as not to incur high investment opportunity costs.

Any suspicion of oscillation in the interest rate from what is regarded as normal will produce modifications in investors' spending decisions as they stake their wagers for best monetary profit. That is why there should be no secrecy on the part of the Monetary Authority as to interest rate levels over time. Also, there should be no unexpected, significant alterations in the basic interest rates in the economy, so that constancy is credible and agents' preference for liquidity will thus demand lower premiums.

Carvalho (1994) draws attention to a valid illustration to represent how monetary policy acts to determine agents' asset portfolio composition:

> it is in this sense that the inverted pyramid is constructed to characterize the Keynesian view of the relationship between currency and other financial assets […] At the vertex is legal tender, and on that vertex all other assets rest, in successive layers, each defined by the institutional arrangements that establish the rules of convertibility among the groups […] and by the relationship among the rates of return obtained in each collection of assets (1994: 43-44).

It is precisely this relationship between currency and the various asset types that grants monetary policy some ability to manage effective demand and affords interest rate management, as an instrument of monetary policy, the ability to influence the real variables of monetary economies. That is, monetary policy acts indirectly on economic activity, initially impacting liquidity levels on the monetary and financial markets. By affecting the liquidity of the various different monetary and financial assets, monetary policy has repercussions on interest rates in the economy and thus influences the real side of the economy (Minsky, 1986).

By way of example, at times of widespread lack of confidence among economic agents, monetary policy can contribute little to balancing the economic cycle, as seen in the illustration represented by the familiar liquidity trap. For this reason, Keynes (1980a: 350) argues that

> It is not quite correct that I attach primary importance to the rate of interest. What I attach primary importance to is the scale of investment and an interested in the low interest rate as one of the elements furthering this. But I should regard state intervention to encourage investment as probably a more important factor than low rates of interest taken in isolation.

The following quotation from the General Theory emphasizes this idea:

> "I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views [...] taking an ever greater responsibility for *directly* organizing investment" (Keynes, 1964: 164, emphasis added).

As for exchange rate policy, throughout his work, Keynes' exchange rate policy thinking and proposals point towards arranging a managed exchange rate regime in order to assure external balance and, particularly, price stability (Ferrari Filho, 2006a: Chapter 3). In his *International Clearing Union* (Keynes, 1980b), Keynes makes this idea clear by signaling that one of the aims of having a fixed exchange rate that is nonetheless alterable to suit circumstances should be to reduce uncertainties about future prices of assets and tradable goods when economic agents take decisions to close exchange contracts.

Moreover, Keynes was concerned to point out that the external dynamics of monetary economies could not do without an instrument to permit balanced symmetries in trade relations between countries. In that connection, Keynes proposed the creation of a multilateral coordinating body that would work to ensure that trade imbalances were cleared automatically, so that deficit countries would not be hostage to the need to attract capital in order to finance their balances of payments.

This multilateral clearance was to be effected through a universally-accepted currency, issued supra-nationally and generated for the sole purpose of operating these multilateral settlements, offering no advantage for use as a store of value. In Keynes' words (1980b: 270), the usefulness of this currency and the trade equilibrium it is designed to achieve reside in the ability:

> to provide that money earned by selling goods to one country can be spent on purchasing the products of any other country. […] we cannot hope to balance our trading account if the surpluses we earn in one country cannot be applied to meet our requirements in another country.

Automatic clearance of trade imbalances would make it possible to mitigate deficit countries' need to attract external capital in order to finance their balances of payments with deficit current trade transactions. For that purpose, controls could be imposed on international capital flows to enable monetary policy to exert more autonomous control over the interest rate. To Keynes, automatic clearance would be a restriction on countries' freedom of economic action, but would enable them to retain greater autonomy over significant domestic economic policy decisions. In his words,

> are we winning one freedom at the cost of another? Shall we have to submit to exchange controls on individual transactions which would be unnecessary otherwise? […] It is not merely a question of curbing exchange speculations and movements of hot money, or even of avoiding flights of capital due to political motives […] The need, in my judgment, is more fundamental. Unless the aggregate of the new investments which individuals are free to make overseas is kept within the amount which our favourable trade balance is capable of looking after, we lose control over the domestic rate of interest (Keynes, 1980b: 275).

Keynes regards a managed exchange rate, automatic clearance of trade imbalances and permission for capital controls as fulfilling two fundamental purposes: (i) they make entrepreneurial expectations less uncertain and (ii) they afford greater freedom to pursue monetary policy, both by hindering exchange rate pass-through effects on domestic prices, as well as by making it possible for the interest rate not to be used the whole time to attract external speculative capital,[8] which can inhibit productive investments. In short, exchange rate policy in Keynes is designed to establish, intertemporally, balanced external accounts and the greatest possible autonomy for monetary policy.

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[8] For this reason, Keynes (1980b: 276) says that "we cannot hope to control rates of interest at home if movements of capital moneys out of the country are unrestricted".

Fiscal policy

Keynesian fiscal policy has direct impact on aggregate demand –more specifically on consumption and investment– and constitutes the main instrument of State intervention. It is anchored in tax policy and in administering public expenditure (importantly, a completely different category from public deficit).

Tax policy is intended, on the one hand, to enable unequally distributed income to be reallocated, either by income tax or inheritance taxes. By expanding the State's spending capacity, on the other hand, it allows aggregate demand to be boosted in the economic system. Lastly, as Keynes (1972) points out, tax policy can also serve to increase available income, thus fostering expansion of effective demand.

Meanwhile, administration of public spending, from Keynes' original perspective, centers on constituting two budgets: the ordinary or normal (current) budget and the capital budget. The current budget relates to the funds necessary to maintain the basic services that the State provides to the general public,[9] while the capital budget relates to the expenditures to expand aggregate demand. Although Keynes believed in the importance of these capital expenditures as automatic stabilizers of economic cycles, he understood that the current budget should always be in surplus. In his words (Keynes, 1980a: 225), "[f]or the ordinary Budget should be balanced at all times. It is the capital Budget which should fluctuate with the demand for employment".

To illustrate this concern with budget balance, Keynes (1980a: 204-205) argues, as part of discussions over what kind of social security system should be built in England after World War II,[10] that it would constitute "a severe burden to meet simultaneously pensions against which no funds have

[9] Public health, education, urban infrastructure, national defense, public safety, social insurance, and so on.

[10] The discussions took place on the Inter-Departmental Committee on Social Insurance, set up in June 1941, mainly between Keynes and the committee's chairman, William Beveridge. For further information, see: Keynes (1980a: Chapter 4).

been accumulated and to accumulate funds for future pensions". Going into this direction.

How then would counter-cyclic fiscal policies be achieved? Keynes (1980a: 278) says that

> it is probable that the amount of [current budget] such surplus would fluctuate from year to year for the usual causes. But I should not aim at attempting to compensate cyclical fluctuations by means of the ordinary Budget. I should leave this duty to the capital Budget.

To Keynes (1980a) the other component of the public budget was the capital budget. This discriminates public expenditures relating to productive investments made by the State in order to maintain stability in the economic system. Such investments should be made by public or semi-public bodies,[11] providing this was done with the clear intention of regulating the economic cycle by supporting entrepreneurs' expectations of effective demand for what they decided to produce in the present.

The Keynesian capital budget could run into deficit, but the surpluses necessarily obtained on the current budget would finance this. Accordingly, any debt occasioned by the capital budget deficit would relate not to State borrowing activities on the financial markets –which might arouse agents' doubts as to the State's solvency and, consequently, its ability to continue fostering entrepreneurial expectations– but rather to "thus gradually replacing dead-weight debt by productive or semi-productive debt" (Keynes, 1980a: 277).[12]

In this way, Keynesian public expenditure policy hinges on balancing the overall budget, even though this may be achieved in the short term by a surplus in the current budget and deficit in the capital budget. Mankiw, in his article, *The Reincarnation of Keynesian Economics*, falls into an error of

[11] According to Keynes, "semi-autonomous bodies [seeking] […] solely the public good […] It is easy to give examples - the universities, the Bank of England, the Port of London Authority, the trend of joint stock institutions […] [They] approximate to the status of public corporations rather than that of individualistic private enterprise" (Keynes *apud* Kregel, 1985: 37).

[12] Dead-weight debt should be understood as debt which does not construct future sources for its payment, such as public debt bonds issued to assure funds to pay previously contracted debts.

interpretation of Keynes' idea when he asserts, without even discussing the dual Keynesian budget, that "deficit spending is, therefore, good for economy" (1991: 5). Besides, Mankiw (1991: 8) argues that "policy makers should be free to exercise their discretion in responding to changing economic conditions and avoid adherence to a rigid policy rule".

As seen above, in Keynes' own words, monetary and fiscal policies should be wisely managed, not just so that their effects are not adverse to the goals of State intervention, but more importantly because economic policy is a rule, a convention, on which entrepreneurs rely in deciding whether or not to invest. The fact that economic policy is conducted according to rules is what makes it workable as a coordinator of economic activity. If economic policy were to act casuistically it simply would not function as a provider of bases for agents' forecasts; rather, on the contrary, it would leave them with even more precarious bases on which to decide how to act; after all, it would be a fiscal policy that changed constantly to suit whatever situations arose.

Another important rule about operationalizing the capital budget is that the public investments must not rival private investments, but must be complementary to them (Carvalho, 1999). Also, the public investments are normally related to social investments, and "[their] […] decisions […] are made by *no one* if the State does not make them" (Kregel, 1985: 37).

According to Davidson (1991: 32), "economic decisions are made by human beings facing an uncertain and unpredictable economic future, while they are moving away from a fixed and irreversible past". Time, therefore, is important in both its expectational and historical dimensions. As long as time is a key variable for agents and for what they take into consideration in order to decide whether or not to act, the true Keynesian fiscal policy of public expenditure cannot be merely an instrument of last resort.

Thus, to Keynes, the main task of the automatic stabilizer is to prevent wide fluctuations by means of a stable, ongoing program of long-term investments originating in the capital budget. Keynes argued that, for the State to be an automatic stabilizer entailed "a long-term [investment] programme of a stable character [that] should be capable of reducing the potential range of fluctuation to much narrower limits than formerly" (Keynes, 1980a: 322).

It was not the State's function to intervene during peaks or slumps in the economic system's progress, but rather to prevent peaks or slumps from occurring. Once the budget for scheduled long-term productive investments has been established, it is easy to cope with any short-term fluctuations that occur by bringing forward certain future measures, as soon as the first symptoms of insufficient effective demand appear.[13]

Minsky (1986), without resorting to the Keynesian notion of segregated budgets and even underlining the importance of occasional short-term budget deficits,[14] argues that private investment deficiencies need to be balanced by Big Government public spending. In monetary economies, he explains, declining profits mean frustrated entrepreneurs and may trigger a whole chain of non-payment of financial liabilities, tending to lead to a critical situation among the institutions operating on financial markets. In this intricate and unstable scenario, where the real and monetary-financial dimensions of the economy are inseparable and mutually dependent, "Big Government must be big enough to ensure that swings in private investment lead to sufficient offsetting swings in the government's deficit so that profits are stabilized" (Minsky, 1986: 297).[15]

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[13] By way of illustration, the effects of the subprime crisis on emerging economies, especially Brazil, corroborate that view. As shown by Ferrari Filho (2009), from late 2008 to early 2009, the notion of the Brazilian economy's decoupling from the world economic crisis was refuted in that Brazil did suffer directly the same impacts as felt by developed countries. In that period, the key indicators of dynamic effective demand in the Brazilian economy (*i.e.*, investment, consumption and exports) declined significantly. However slow Brazil's Monetary Authorities (BMAs) were to act at first, the fiscal and monetary policies they implemented in the first quarter of 2009, to stimulate aggregate demand in response to the crisis were effective in the end, even to the point of reversing the economic recession in Brazil. Overall, if the BMAs adopted standing automatic stabilizers on effective demand, such as proposed by Keynes, effective demand crises like the one experienced by Brazil's economy in 2008 and 2009 would have less impact and pass quickly.

[14] Minsky adds, however, that over time the public budget must necessarily be balanced, among other things because the public sector is an agent that needs private financing that will be granted only if economic agents believe that public revenue gathering will be sufficient to answer for the State's financial payments structure. For further details, see Minsky (1986: 303).

[15] It is for no lesser reason that Minsky (1986) proposes that Big Government should be of a size, in relation to Gross Domestic Product (GDP), equal to, or greater than, the rate of gross capital formation to GDP, *i.e.*, the country's investment rate.

Minsky (1986) also proposes that action by Big Government should coordinate with action by a permanent Big (Central) Bank, on the one hand, regulating the activities of monetary and financial institutions (which, incidentally, are operating with much more unstable financial innovations than those contemplated by Keynes in the first half of the 20th century) so as to deter them from constructing increasingly fragile positions and, on the other hand, at the first sign of loan defaults, acting as lender of last resort. In this way, the Big Bank's monetary policy should maintain the monetary-financial system in sound, credible financial positions, so that, in the event a mounting lack of confidence among entrepreneurs' lead to unemployment and income stagnation, no spate of bankruptcies will ensue and lead the economic system into a major depression.

If conducted continuously, automatic stabilization will not focus on containing moments of economic crisis; rather, whenever signs of surplus aggregate demand are perceived, capital budget investment projects will be postponed so that expanding national income is not corroded by any inflation resulting from scarce supply. Therefore, action to contain short-term fluctuations should not be limited to fostering periods of expansion, but should also be applied to avert episodes of surplus aggregate demand.[16]

Returning to Keynes, his proposal of a capital budget rests on the principle that, by fostering productive institutions, it is responsible for generating its own surplus in the long run. In order to balance public finances, it is enough in the short term not to incur a current deficit, given that surpluses called for in the current budget finance any deficits in the capital budget. On the other hand, return on public investments tends, in the long term, to balance the capital budget itself. In Keynes' words (1980a: 319-320), the "capital expenditure would, at least partially, if not wholly, pay for itself".

This possibility of a balanced capital budget in the long term makes the overall public budget much more rational and viable,[17] fostering over

[16] For examples of situations where the State should act to cool economic activity, see: How to Pay for the War (Keynes, 1972).

[17] In 1933, in *The Means to Prosperity,* Keynes (1972) argues that policies to expand public spending in times of stagnation, recession or depression are means for national treasuries to increase their

time the construction of surpluses and consequently public saving in both components of the Keynesian budget, signaling greater intervention capability for the State to act counter-cyclically. This makes budget deficits an even more remote likelihood; they would occur, confirms Keynes (1980a: 352), if "the volume of planned investment fails to produce equilibrium". In, and only in, such conditions,

> the lack of balance would be met by unbalancing one way or the other the current Budget. Admittedly this would be a last resort, only to come into play if the machinery of capital budgeting had broken down (Keynes, 1980a: 352).

Nonetheless, Keynes also argues that to leave no doubt about his true intentions in prescribing fiscal policy rules, "so very decidedly I should cut down all this and not lead the critics to think that the Chancellor is confusing the fundamental idea of the capital budget with the particular, rather desperate expedient of deficit financing" (Keynes, 1980a: 353-354).

This fundamental role that the Keynesian approach assigns to investment spending *vis-à-vis* spending on consumption, with regard to the dynamics of aggregate demand, concentrated especially on three aspects.

Firstly, the accumulated stock of wealth in a society depends essentially on entrepreneurs' investment decisions, because these decisions drive the use of machinery, equipment and, most importantly, human work to generate income and wealth.

Secondly, as in Keynes (1972),[18] the initial increase in wealth resulting from resources' passing from one individual to others in the act of investing, is able to produce a circuit of spending and thus, by the multiplier effect of the investments, new increases in income. Part of what is received by an agent involved in a decision to invest is then expended on consumption, and so on successively in a sequence of agents in the society. Overall, this multiplication of income heightens the state of confidence among entrepreneurs that their

revenue gathering and make it easier to achieve balanced budgets, given the time necessary between spending turning into remuneration and this in turn become effective consumption.

[18] The argument can also be observed in Ferrari Filho (2006a) and Carvalho (2008).

wagers will materialize in future revenues that will offset the expenditures they have made. According to Keynes (1972: 339-340),

> but if the new expenditure is additional and not merely in substitution for other expenditure, the increase of employment does not stop there. The additional wages and other incomes paid out are spent on additional purchases, which in turn lead to further employment […] Moreover, in so far as the increased demand for food, resulting from the increased purchasing power of the working classes, served either to raise the prices or to increase the sales of the output of primary producers at home and abroad, we should today positively welcome it. It would be much better to raise the price of farm products by increasing the demand for them than by artificially restricting their supply.

Lastly,

> the question then arises why I should prefer rather a heavy scale of investment to increasing consumption. My main reason for this is that I do not think we have yet reached anything like the point of capital saturation. It would be in the interest of the standard of life in the long run if we increased our capital quite materially (Keynes, 1980a: 350).

It is important that consumption spending should grow. However, it will play a prominent role when a country's stock of capital reaches the saturation of overall scarcity that permits assets to become profitable. At that moment, public policies will be applied to foster consumption, which are essential to stimulating entrepreneurs' short-term expectations. Until that point is reached there is room for the society's stock of capital to grow and, consequently, for its social wealth –fundamental to improving quality of life and basically dependent on investment spending– also to expand.

As explained above, investment should be conducted with a view to achieving complementation between private and public initiatives, with the latter functioning preeminently, in the long term, to foster the former and thus to stabilize cyclic fluctuations in the economic system. It is worth stressing once again that agents' expectations are the factor that destabilizes the system and that, therefore, it is on them that Keynesian economic policy will act. So clear should this be, mainly to entrepreneurs, that Keynes develops the notion of the capital budget in order that productive investors can rely on the State's commitment to action.

In an uncertain world, where agents risk their power of command over social wealth in order to gain more such power in the future, economic policy should be the greatest source of solidity that private enterprise has contact with. It should guarantee a dynamics of increasing wealth which, consequently, maintains and expands the society's inclination to consume, thus enhancing investors' prospects. On this point, Minsky (1986: 6) argues that "if the market mechanism is to function well, we must arrange to constrain the uncertainty due to business cycles so that the expectations that guide investment can reflect a vision of tranquil progress".

As Marcuzzo (2005: 2) argues, Keynes' theory proclaims the whole time what needs to be done in order "to sustain the level of investment, but it should be interpreted more in the sense of 'stabilizing business confidence' than a plea for debt-financed public works".

This is because,

> [Keynes'] reliance on *socializing investment* rather than a fiscal policy aimed at smoothing out consumption levels over the cycle shows his concern for the size of the deficit, and the importance ascribed to market incentives to bring about the desired level of employment (Marcuzzo, 2005: 2, emphasis added).

In short, this shows that Keynesian economic policy, in both conception and practice, is intended to maintain levels of effective demand for the purpose of mitigating involuntary unemployment by stabilizing business peoples' state of confidence. The desired result to be achieved through Keynesian economic policies is construction of a society with a trajectory that perpetually enjoys economic efficiency, social justice and individual freedom.

Final remarks

Keynes' concern had to do essentially with how to foster the greatest possible social wealth that could be enjoyed by the greatest number of individuals

–a key element in this production of wealth being entrepreneurs and their animal spirits, confronted the whole time by the uncertainty inherent to the future. In that dilemma and consistent with his concern, Keynes proposed State intervention as a way of assuring a basis for entrepreneurial expectations.

In an uncertain world, where agents risk their power of command over social wealth in order to gain more such power in an unknown and incalculable future, economic policy should be the greatest source of solidity that private enterprise has contact with. This makes it possible to offer a minimum guarantee of effective demand as a basis for decisions to make the productive investments which determine growth in social wealth and, consequently, maintain and expand the society's inclination to consume, fostering investors' prospects and preventing the emergence of instability in the dynamics of monetary production economies.

Keynes was known not to want capitalism to fail. On the contrary, he wanted to reform and salvage it. For that purpose, he rejected *laissez-faire* capitalism and proposed a regulated capitalism where market dysfunctions were offset by State intervention to guarantee and sustain full employment, on the one hand, and to attack excessive concentration of income and wealth, on the other.

The recommendations of Keynes and his followers for reform of the capitalist system were based on State intervention in the economy, either by way of public policies or by normative rules indispensable to building an institutional environment favorable to the socialization of investments between public and private agents.

In that respect, in the course of his life and building on his analysis of the operating logic of monetary economies, Keynes presented numerous proposals for the institutional reform of capitalism, including those for restructuring the international monetary system (Keynes, 1980b). Common to all his proposals is the idea that sustainable economic growth and social development should consist in the efforts of those who do not commit the error of the pessimist. As Keynes wrote in *Economic Possibilities for Our Grandchildren* (1972: 322):

> I predict that both of the opposed errors of pessimism which now make so much noise in the world will be proved wrong in our time –the pessimism of the revolutionaries who think that things are so bad that nothing can save us but violent change, and the pessimism of the reactionaries who consider the balance of our economic and social life so precarious that we must risk no experiments".

In that particular, to close, it is worth stressing that the errors of neither pessimists nor reactionary conformists constitute a viable alternative for Keynes. Famously, to Keynes, the valid alternative in addressing problems of political economy (and economic policy) was to formulate solutions that involve "a blend of economic theory with the art of statesmanship" (1972: 336).

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